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CASH AND CASH EQUIVALENTS

Cash includes cash in banks (savings banks, S&L, etc.) and cash on hand ("vault" cash, cash in ATM machines, etc.). Cash equivalents include income-producing accounts (deposits) and certificates of deposits (with 3 months or less original maturity) in banks, savings banks, and S&Ls, etc. Because cash is the most liquid of assets, and is susceptible to being lost, stolen, and miscounted, federal credit unions should have an effective system of internal control for cash receipts, disbursements, recording, reconciliation, and review (audit).

CASH ON DEPOSIT

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.

Balances on Deposit

This classification represents balances on deposit at banks, credit unions, S&L's, corporates, etc. that the credit union may use to make daily deposits, replenish change funds, pay operating expenses, write loan checks, etc. These accounts should be reconciled on at least a monthly basis.

Deposits in Transit

Deposits in transit are part of the reconciliation. They represent deposits made at another financial institution that was immediately reflected on the credit union's books but for which credit was not yet received at the financial institution.

Monetary Control Reserve Deposits

This account is used to record monetary reserves held on deposit with the Federal Reserve System against its non-personal time deposits. The cash is held at the Federal Reserve in a non-interest bearing account.

Entries in the Journal and Cash Record

This account should be debited for any cash deposits made with the Federal Reserve System in the "Miscellaneous-Debit" column. It should be credited when the funds are withdrawn in the "Miscellaneous-Credit" column.

Illustrative Entries

a) When a cash deposit is made into the Federal Reserve System:

Dr.-Monetary Control		
Reserve Deposits	\$5,450	
Cr.-Cash		\$5,450

b) When the balance of the fund can be reduced and the funds are withdrawn:

Dr.-Cash	\$1,000.00	
Cr.-Monetary Control Reserve		
Deposit		\$1,000.00

CASH ON HAND

Change Fund

An FCU's board of directors may authorize the establishment of a Change Fund after it considers whether there is a need for it. This account is provided for those federal credit unions that maintain a cash fund for making change or for cashing checks. Other purposes for which a change fund may be used are to disburse share withdrawals or loans in cash or for redeeming U.S. Savings Bonds in cash. The board of directors must ensure that adequate safeguards and accountability exist to protect the fund.

This account is also used to reflect increases made to the change fund when to meet temporary demands for cash, such as on member's payday. Funds involved in these temporary increases to the change fund should be re-deposited as soon as the need for them is served. In the event the actual cash (currency and coins) is depleted by members' checks cashed

from the fund, such checks should be deposited in the bank with the regular deposit and this account credited with the amount of the checks deposited. The fund should be replenished only by credit union checks which are drawn for the purpose and charged to this account.

Entries in Journal and Cash Record

Debit this account in the "Miscellaneous-Debit" column and credit Cash in the "Cash-Paid-out" column with the amount withdrawn from the bank by check to establish or to increase the fund. Credit this account in the "Miscellaneous-Credit" column and debit Cash in the "Cash-Received" column with the amount of the fund re-deposited.

Posting to General Ledger

Entries to this account are posted individually from the "Miscellaneous" columns of the Journal and Cash Record.

Verification of Fund

The amount of the fund should be verified by a count at the end of each business day. When the fund or portions thereof are handled by more than one person, precautionary measures to establish the responsibility of the individuals concerned should be taken.

"Fluctuating" Change Funds

The recordkeeping procedures in connection with Change Funds will prove suitable for credit unions with normal change fund activity. However, some credit unions may feel a need to adopt what is commonly referred to as "fluctuating" change funds. By "fluctuating" it is meant that the amount of cash in the fund will vary from time to time as a result of normal operations, and the fund will not be promptly replenished. In the interest of reducing the hazards in connection with cash handling, a "fluctuating" change fund can be authorized in order to:

a) Avoid the hazards of transporting currency to the bank.

b) Avoid the hazards of retaining more currency in the credit union office than is necessary for immediate needs.

The need for transporting currency to the bank is lessened by the practice of depositing checks instead of currency, whenever possible. In many cases, change fund currency is depleted through cashing members' checks, share drafts, or through making change for members' payments made by check. Frequently, this will result in the total of the checks and share drafts on hand at the end of the day being greater than the total of the vouchers representing payments to the credit union. If the credit union, in such a case, has no immediate need for replenishing the change fund, only the checks and share drafts need be deposited and the change fund can be reduced by the amount that the checks exceed the receipts for the day. Assuming that the receipts total \$800 and the checks total \$1,200, the entry should be:

Example 1:

Dr.-Cash	\$1,200.00	
Cr.-Shares		\$580.00
Cr.-Consumer Loans		200.00
Cr.-Interest on Loans		20.00
Cr.-Change Fund		400.00

In instances where the cash receipts for the day exceed the amount of the checks and share drafts, the entire amount of cash receipts must be deposited as provided in Section XIII of the Federal Credit Union Bylaws. However, if a change fund is in use, a credit union desiring to deposit only checks and share drafts (as a safety measure) may do so by increasing the change fund by the amount of the currency in the day's receipts. This can be accomplished by drawing a credit union check in the amount of the currency received during the day.

Assuming that receipts totaled \$900 of which \$800 is in the form of checks and share drafts, the entries would be:

Example 2:

(a) To record the credit union check drawn in the amount of the currency.

Dr.- Change Fund	\$100.00	
Cr.-Cash		\$100.00

(b) This check is deposited along with the checks received in the day's business to make up the debit to cash

Dr.- Cash	\$900.00	
Cr.-Shares		\$680.00
Cr.-Consumer Loans		200.00
Cr.-Interest on Loans		20.00

As previously discussed, credit unions may disburse share withdrawals or loans, or both, in cash. In the interest of reducing hazards, replenishment of the change fund may be delayed and if the officials so desire, the change fund can be reduced by the amount of the cash share and loan disbursements. Assuming that cash share and loan disbursements on any day amounted to \$500, the entry would be:

Example 3:

Dr.- Shares	\$200.00	
Dr.- Consumer Loans	300.00	
Cr.-Change Fund		\$500.00

To avoid a complex entry in the Journal and Cash Record, which could result from combining the above entry with other entries involving change funds, the above should be a separate entry. It should be supported by the cash disbursement vouchers which should be summarized on a Journal Voucher, or its equivalent.

By way of summary, fluctuation in the change fund that results from normal operations may occur as follows:

a) Change fund will be reduced:

- By excess of checks and members' share drafts over cash receipts (example 1).

- By cash share and loan disbursements (example 3).

b) Change fund will be increased:

- By replenishment checks drawn on the credit union's depository and cashed at the bank.
- By replenishment checks cashed from credit union receipts (example 2).

Regardless of the manner in which the change fund may fluctuate, change fund cash must be verified each day and cash over and short recorded, if applicable.

It is possible that some credit unions may have change funds of such a large amount that continual fluctuations occur without the need arising to replenish the fund with reasonable regularity, or to deposit excess currency. In such a situation, the change fund does not serve its intended purpose. Accordingly, the officials should relate the size of the change fund with the needs of the credit union and its surety bond coverage and, if necessary, reduce the amount of the change fund.

Illustrative Entries

a) When the change fund is set up or increased:

Dr.-Change Fund	\$50.00	
Cr.-Cash		\$50.00

b) When the change fund is decreased or eliminated:

Dr.-Cash	\$50.00	
Cr.-Change Fund		\$50.00

Detailed Transactions

Debit:

- a) With amount of cash disbursed to establish the Change Fund.
- b) With amount of cash disbursed to increase the Change Fund.

Credit:

- a) With amount of member's checks cashed from the Change Fund and deposited in the bank with the regular deposit.
- b) With amount of cash received representing a decrease or the elimination of the Change Fund.

Petty Cash

This account records the authorization of a Petty Cash Fund by the board of directors. The purpose of petty cash funds is for making incidental payments such as postage and other expense items of less than \$50. Payments from the petty cash fund must be evidenced by receipts or signed petty cash vouchers and are not posted to the Journal and Cash Record.

Setting up Petty Cash Fund

Debit this account in the "Miscellaneous-Debit" column of the Journal and Cash Record for the gross amount withdrawn by check from the bank to establish a petty cash fund. No subsequent debits or credits to the account are made except for the purpose of increasing or decreasing the amount of cash to be maintained in the fund. The amount set up in this fund should not exceed the maximum authorized by the board.

Posting to the General Ledger

Posting to this account in the General Ledger is made from the "Miscellaneous" columns of the Journal and Cash Record.

Payments for Petty Cash Fund

As payments are made out of the fund, receipts or signed petty cash vouchers should be obtained and held with the balance of the cash in the fund. Thus,

the actual cash and/or receipts will always equal the total amount of the fund. No entries are made in the Journal and Cash Record for individual petty cash payments.

Replenishment

The petty cash fund is restored in full prior to the end of each dividend period, and at other times when necessary, in order that expenditures made may be recorded and that the cash in the fund will be equal to the balance in the General Ledger. When replenishment of the fund is necessary, a Journal Voucher is prepared and a check drawn in favor of "Petty Cash". Upon cashing the check, actual cash for the total of the fund should be on hand. The receipts, which were received when disbursements were made from the fund, equaling the amount of the check is attached to the Journal Voucher or filed with other paid bills.

Entry in Journal and Cash Record

When the petty cash fund is replenished, the transaction is entered in the Journal and Cash Record by debiting all of the applicable expense accounts and crediting the Cash account (Cash-Paid Out). Unless it is applicable, the total cost of the replenishment should not be debited to "Miscellaneous Operating Expenses". This entry does not affect the Petty Cash account as set up on the books.

Changes in Amount of Fund

If it is decided to reduce the amount of cash in the fund, a Cash Received Voucher is prepared. At the end of the day when the cash received transactions are recorded in the Journal and Cash Record, the amount should be entered in the "Miscellaneous-Credit" column as received from "Petty Cash". The amount taken from the fund is deposited with other cash received that day.

Segregation of Fund

The petty cash fund must be kept physically separate and apart from all other cash. The supervisory committee should verify the balance of the petty

cash fund periodically by conducting surprise cash counts.

Illustrative Entries

- a) To establish the petty cash fund:

Dr.-Petty Cash Fund	\$25.00	
Cr.-Cash		\$25.00

- b) To replenish the fund:

Dr.-Various Operating Ex- pense Accounts	\$16.79	
Cr.-Cash		\$16.79

- c) To reduce or eliminate the petty cash fund:

Dr.-Cash	\$20.00	
Cr.-Petty Cash Fund		\$20.00

Detailed Transactions

Debit:

- a) With amount of cash disbursed to establish the Petty Cash Fund.
- b) With amount of cash disbursed to increase the Petty Cash Fund.

Credit:

- a) With amount of cash received (or vouchers recorded) representing a decrease in the Petty Cash Fund or creation of the Fund.

GENERAL CASH HANDLING AND ACCOUNTING PROCEDURES

Accounting for Cash Receipts

Whenever cash is received, a Cash Received Voucher or equivalent should be prepared. It is recommended that the voucher be filled in by the members for all members' payments to the credit union. The

person receiving the cash should enter the amount of the payment and the purpose in the member's Passbook or equivalent. The Cash Received Voucher serves as a posting medium from which entries are made in the Individual Share and Loan Ledgers. (Note: On-line, data processing systems have replaced the need for passbooks and can provide the member with current share and loan balances.)

At the end of each business day the totals of the Cash Received Vouchers for that day should be added. The total of the vouchers should be the same as the total cash received and on hand for that day. If it is not, the "Cash Over and Short" should be charged or credited. After the totals of the vouchers are reconciled with the cash on hand and the summary voucher prepared, the amounts appearing on the summary voucher should be entered in the Journal and Cash Record and the amounts on the individual vouchers should be posted to the Individual Share and Loan Ledgers. The use of total payment vouchers and the handling of mail receipts are discussed under another section.

The summary voucher should be attached to the individual vouchers. The totals of the individual amounts paid in on Shares, Share Certificates, Loans, Interest on Loans, Fees and Charges, etc., may be determined by the use of an adding machine. The adding machine tape should be attached to the summary voucher.

Cash received by the credit union must be deposited in the bank promptly as required by Article XIII of the Bylaws. Deposits in the bank will ordinarily consist of an entire day's receipts as entered in the Journal and Cash Record. If the amounts are small, more than one day's total receipts may be combined in a single deposit provided that no funds are held for more than the time limits specified in the Bylaws. Credit unions, however, occasionally find it expedient to deposit funds in the bank during the course of a business day and to include in the deposit all receipts up to the time the deposit is prepared in order that comparatively large amounts of cash will not be on hand in the credit union. Usually, such credit unions will prepare two deposits for each day's business, but only one entry in the Jour-

nal and Cash Record need be made. The total of the two deposits should agree with the cash receipts for the day as shown by the entry.

Credit unions making more than one bank deposit during a business day may "cut off" the day's business at a certain specified time, usually at the time of the bank deposit. All transactions subsequent to the cut off time are considered as the business of the following day and are so dated. The establishment of a policy by the board of directors for cutting off the day's business should be made known to the members. In order that cash can be easily traced, the bank deposits should be identifiable with the cash receipts as entered in the Journal and Cash Record. So that the credit union will have a record of the persons who made payments in case the cash receipts are lost or stolen before they have been deposited in the bank, the Cash Received Vouchers should immediately be segregated from the cash. Checks should be promptly endorsed "for deposit only" when they are received to reduce the possibility of their being negotiated if they are stolen. For internal control purposes, the deposit slips should be prepared in duplicate for all bank deposits and the duplicate be retained in the credit union files. Showing bank transit numbers for checks included in the deposit is suggested.

The cash of the credit union must be kept separate and apart from all other cash. Under no circumstances should the personal or other cash of the officers and employees be commingled with the credit union's cash.

Accounting for Disbursements

Disbursements should be made by check, except those authorized from petty cash and wire transfers. The canceled checks serve as receipts for money paid out by the credit union. Although no standard form of check is prescribed, there are certain advantages to the use of checks which have the check number, the credit union's name and spaces for signature and countersignature preprinted. Regardless of the form of check used, all checks should be pre-numbered.

Spoiled checks should be marked "Void" and filed for audit purposes in their regular numerical order with their applicable bank statements and canceled checks.

Unless the board of directors has authorized otherwise, all checks should be signed and countersigned. The countersigning provides an additional element of control over the disbursements. The financial officer, assistant financial officers, manager and assistant managers may be authorized to sign checks. The executive officer and the assistant executive officer(s) should be authorized to countersign. The board of directors may resolve that checks can be issued with the signature of only the financial officer, assistant financial officer, manager or assistant manager. Before acting on such a resolution, the board must be sure that adequate internal controls are in effect and that countersignatures are no longer required to insure the satisfactory operation of the credit union.

Each bank usually has its own resolution form which corporations fill out in connection with the authorization of certain officers to sign and/or countersign checks. For this reason, no standard resolution form is prescribed.

If the checks used by the credit union do not provide for a duplicate copy and voucher format, a Journal Voucher or its equivalent, should be prepared for each disbursement. Amounts disbursed are posted to the "Cash-Paid Out" column of the Journal and Cash Record.

For each disbursement, a Journal Voucher or its equivalent should be prepared. This form should be used as a source for all entries in the Journal and Cash Record other than cash receipts. It can also be used for non-cash transactions, such as transfers from shares to loans. However, when the form is used for this purpose, it should describe the reason for the entry on the face or reverse side of the form.

The Journal Voucher serves as a convenient medium for posting items to the Individual Share and Loan Ledgers. Spaces should be provided on the form to show who approved or authorized the disbursement

and the signature of the person receiving the check. Since the member's signature should appear on the canceled check, members do not need to sign the Journal Voucher.

The use of a Journal Voucher Form is optional; its use, however, is strongly recommended to standardize and simplify the means for showing authorization of disbursements, transfers and Journal entries and to keep the types of posting media to a minimum. A substitute form can be developed such as a source document for posting using electronic data processing (generally requires carbon copies). However, in order to serve the same needs served by the Journal Voucher, most of the information appearing on the Journal Voucher will need to appear on the substitute form. For electronic data processing (EDP) posting, transaction processing codes should be included.

Each check should be posted individually in the Journal and Cash Record in numerical order from the information provided on the Journal Voucher form. Entries should also be made in the member's Individual Share and Loan Ledger for all transactions with the member, such as share withdrawals and loans made.

Non-cash transactions may be summarized on a Journal Voucher form or its equivalent. This summary voucher should show the total of the day's non-cash transactions and should be attached to the individual vouchers. In such a case, the summary voucher will be the basis for the daily summary entry in the Journal and Cash Record for non-cash transactions.

The credit union may issue duplicate checks to payees who have lost their original checks. In such cases, a stop payment order to the bank should be issued against the original check. Before a new check is issued, it should be determined from the bank that the original check has not been paid. In doing so, credit unions may require an indemnity bond from the payee if circumstances warrant such action. The issuance of a duplicate check should be recorded in the Journal and Cash Record in "Date", "Account No.", "Name of Item", and "Check No."

columns with the purpose for its issuance noted in the "Name of Item" column. It is suggested that a cross-reference be made on the line on which the original check was entered.

If a duplicate check is issued in place of an original check still carried as outstanding in the cash amount, no entry of the amount should be recorded in the "Cash-Paid Out" column. If a duplicate check is issued in place of an original check which was transferred to Accounts Payable or Other Income, the new check number and the number of the check being replaced must be recorded. The amount of the duplicate check should be credited in the "Cash-Paid Out" column and debited to "Accounts Payable", or "Other Income", as required, in the "Miscellaneous-Debit" column.

Member's Check and Drafts Returned

When the bank returns a member's check or draft because of insufficient funds or any other reason, an entry should be made debiting "Other Accounts Receivable", and crediting "Cash", for the amount of the check plus any charges made for returning the check or draft. This entry sets up the check temporarily as an asset or receivable due from the member pending a determination of its collectibility. The member should be contacted immediately and the amount due collected from him/her. Upon payment by the member of the amount due, a reversing entry should be made debiting the "Cash" account and crediting the "Other Accounts Receivable" account.

It is suggested that the amount collected be deposited separately in order that all checks or drafts returned and their subsequent redeposit can be easily traced through the credit union's records. A memorandum notation of the checks or drafts returned should be made on the member's Individual Share and Loan Ledger. The subsequent disposal of the check or draft, either by the member making it good or by charging it back against his/her account, should also be noted on the member's individual ledger.

The board of directors should determine whether the service charges in connection with returned checks or drafts are to be charged to the members con-

cerned or are to be considered a credit union expense item. The amount of the service charge should, therefore, be either a debit to "Other Accounts Receivable" (or to the member's share account if the check or draft is not made good) or to "Bank Service Charges", depending upon the policy of the board. A fee may be assessed to members to recover costs involved in processing checks or drafts returned but the fee may not be in the nature of a penalty. The fee may reflect, but not exceed, the direct and indirect costs involved in processing checks or drafts returned for insufficient funds. If the member does not make good on the returned check within 1 week following its return by the bank, the credits originally made should be reversed. Assuming the original check covered both shares and a payment on loan and interest, the entry in the Journal and Cash Record to reverse the original credits would be:

Dr.-Shares	\$5.00	
Dr.-Loans	24.00	
Dr.-Interest on loans	1.00	
Cr.-Other Accounts Receivable		\$30.00

Dr.-Cash	\$10.00	
Cr.-Other Fees and Charges		\$2.00
Cr.-Shares		\$8.00

Posting to General Ledger

When the transactions which have been entered in the Journal and Cash Record are posted to the General Ledger accounts, the Cash account is debited with the total of the "Cash-Received" column and credited with the total of the "Cash-Paid Out" column. These totals are usually posted at the end of each month.

Depositing Cash

All cash received should be deposited in the bank account within the time provided by Article XIII of the *Federal Credit Union Bylaws* (usually daily). Deposits should ordinarily be made in amounts which exactly equal one or more day's cash collections, as shown on the daily summary vouchers and in the Journal and Cash Record.

*Illustrative Entries*Receipt of Cash:

a) When entrance fees (*Federal Credit Union By-laws*, Article II, Section 2, if authorized by the Board) and payments on shares are received from members:

Dr.-Cash	\$10.00	
Cr.-Other Fees and Charges		\$2.00
Cr.-Shares		8.00

b) When an installment on a loan is paid and interest and late charges are collected:

Dr.-Cash	\$11.20	
Cr.-Loans		\$10.00
Cr.-Interest on Loans		1.00
Cr.-Fees and Charges		.20

c) When payment is received for: loan interest of \$15.50, legal and collection expenses of \$10 deducted by an attorney or collection agency from the payment made by the borrower, and the remaining funds of \$72.50 applied to the borrower's loan balance (loan has not been charged off):

Dr.-Cash	\$78.00	
Dr.-Collection Expense	10.00	
Cr.-Interest on Loans		\$15.50
Cr.-Loans		72.50

d) When a refund, recovery, or adjustment of an expense is received:

Dr.-Cash	\$2.00	
Cr.-Appropriate Operating Expense Account		\$2.00

e) When interest or dividends are collected on investments:

Dr.-Cash	\$12.50	
Cr.- Income from Investments		\$12.50

Disbursement of Cash by Check or Bank Charges***Illustrative Entries***

a) When a member withdraws cash from his/her share account:

Dr.-Shares	\$20	
Cr.- Cash		\$20

b) When a loan is made to a member:

Dr.- Loans	\$10	
Cr.- Cash		\$10

c) When a member having a note outstanding with an unpaid balance of \$10.00, gets a new note for \$50.00, and receives a \$40.00 check and his old note:

Dr.- Loans	\$50	
Cr.- Cash		\$40
Cr.- Loans		10

Note: If the Journal Voucher is used, the new loan should be entered as a debit for the gross amount, the balance of the old loan as a credit item, and the voucher should show the net cash paid opposite "Amount" on the check.

d) When an expense is incurred and paid upon receipt of bill:

Dr.- Appropriate Expense Account	\$15	
Cr.- Cash		\$15

e) When a check is drawn on the bank to establish a petty cash fund:

Dr.- Petty Cash	\$10	
Cr.- Cash		\$10

f) When a loan is made to another credit union on its note, interest to be paid at maturity and check issued:

Dr.- Loans to Other Credit Unions	\$1,000	
Cr.- Cash		\$1,000

g) When the change fund is set up or increased:

Dr.- Change Fund	\$50	
Cr.- Cash		\$50

h) When a service charge is made by the bank:

Dr.- Bank Service Charges	\$1.75	
Cr.- Cash		\$1.75

Detailed TransactionsDebit:

a) With cash receipts.

b) Bank reconciliation "addition" adjustments to the credit union's book balance.

c) Checks or drafts for insufficient funds when they are re-deposited.

Credit:

a) With cash disbursements made by check.

b) With bank services charges assessed by the bank, and other book balance "deduction" adjustments on the bank reconciliation.

c) Checks or drafts returned for insufficient funds.

Balancing out Teller's Funds

With credit union growth and expanded activities, the cash procedures needed to properly serve the members sometimes become more complex. In this section and the next section on "Special Procedures for Disbursements" some of the procedures and forms pertinent to the multi-service credit unions are discussed.

At the close of business each day, each teller should balance the receipts and disbursements for the day to the cash count. This should be accomplished by completing a "Teller's Daily Cash Sheet" or equivalent. In balancing the receipts/disbursements to the cash count the following steps should be followed:

a) Cash Count

- 1) Count all cash (bills and coins) in the cash drawer and enter the amounts on the form and total.
- 2) List and count the checks and share drafts received. At the time they are received, share drafts should be stamped "paid" or "canceled" to prevent their being removed from the daily work and presented for payment again. If only a few have been received, they can be entered separately in the cash count section. If a large number are received, an adding machine tape can be prepared or a separate listing can be attached to the form. No matter what method is used, the teller should identify each item. If a separate listing of the checks/share drafts is prepared only the total amount of the items need be shown in the cash count section.
- 3) Add the cash on hand and checks and share drafts received to arrive at the total for the cash count.

b) Change Fund

- 1) Determine the closing change fund amount. This can be determined by taking the opening change fund and adjusting it for increases in funds received or decreases in funds for the day. For each increase or decrease to the change fund, the teller should have a signed receipt showing the transfer of the funds to or from another teller or the Head Teller.
- 2) Enter the opening change fund and any increases to the change fund in the receipts column. These figures should be shown separately.

- 3) Enter all decreases to the change fund in the disbursements column.

c) Receipts

- 1) Prepare a Summary Cash Received Voucher. This is accomplished by adding each total on the individual cash received vouchers. The total of these items should then be entered on the Daily Cash Sheet under the appropriate heading.
- 2) Add separately the amounts for payments on shares, entrance fees, late charges, interest on loans and loans. Total. This total should also appear on the Summary Cash Received Voucher.
- 3) In the space provided on the form, identify and include any miscellaneous receipts.
- 4) Total the receipts from members and miscellaneous receipts to arrive at the total cash receipts.

d) Disbursements

- 1) Prepare Summary Journal Voucher for the items disbursed in cash. This would include cash share withdrawals (including cash withdrawals from a share draft account), loans or advances on lines-of-credit and savings bond redemptions. The total of each item and the grand total should then be entered on the Daily Cash Sheet under the appropriate headings.
- 2) In the space provided on the form ("Other Disbursements in Cash") identify and include any miscellaneous cash disbursements.
- 3) Total the items described in (1) and (2) above to arrive at total cash disbursements for the day.

e) Balancing

- 1) Add total cash receipts, opening change fund and any increases to the change fund to arrive at total cash.
- 2) Add total disbursements in cash and any decreases to the change fund to arrive at total disbursements.

3) Subtract the total of disbursements and change fund decreases from the total cash receipts to arrive at the closing change fund balance. This figure should agree with the total of the cash count. If the figures do not agree, all figures should be rechecked for errors. If the difference cannot be located after extensive checking, and it is not material, the difference may be entered as "Cash Over or (Short)" on the "Teller's Daily Cash Sheet".

4) Depending on the nature of the cash difference, add or subtract the amount from net cash proceeds to arrive at an adjusted balance. The adjusted balance should agree with the total of the cash count.

5) Reconcile the teller's change fund. If the teller is assigned a specific amount to be maintained in the change fund and the disbursements for the day exceed receipts, the change fund will need to be replenished. The change fund does not have to be replenished if the credit union uses a fluctuating change fund.

Reconciling the Cash on Hand

After the individual tellers have balanced out their daily business, the cashier (Head Teller) should consolidate all teller activity on the Cashier's Daily Summary. This procedure is necessary so that the bank deposit can be prepared and the cashier can determine if the change fund will be adequate to begin operation the next day. The consolidated totals for each item are also needed for posting the daily activity to the Journal and Cash Record.

The use of these forms, or their equivalent, will assist management by providing summarization and records for reconciling and controlling funds on hand.

Check Endorsements

There are three kinds of endorsements that are generally presented to a credit union on a check or draft. These three endorsements are:

a) Blank Endorsement - This consists of the endorser's name written on the instrument or the paper

firmly affixed thereto for that purpose. If an instrument has been drawn payable to "cash" and is endorsed in blank, it becomes payable to bearer and may be negotiated by delivery, without endorsement. For example, if a check is made payable to "John Doe or Cash" and signed by John Doe, as bearer, it would not have to be signed on the reverse side by him because it becomes a blank endorsement. Nevertheless, it is a sound policy to require the member to sign these checks.

b) Special Endorsement - This endorsement specifies the person to whom or to whose order it makes the instrument payable. Any check specifically endorsed becomes payable only to the person whose name appears on the instrument and can only be paid when that person's endorsement is affixed to the back of the instrument. If John Doe writes a check, "Payable To The Order Of Bill Smith", the check cannot be honored until Bill Smith endorses the check on the back.

c) Restrictive Endorsement - A person who endorses an instrument may impose certain restrictions upon his endorsement. An endorsement is restrictive which either:

- 1) Is conditional;
- 2) Purports to prohibit further transfer of the instrument;
- 3) Includes the words "for collection", "for deposit", "Pay any bank", or the terms signifying a purpose of deposit or collection; or
- 4) Otherwise states that it is for the benefit or use of the endorser or other persons.

Total Payment Vouchers

A Total Payment Voucher may be used as a means of speeding up window activity. This is particularly useful where level-payment methods are used for collecting loan and interest payments and where members' individual accounts are not posted at the window. Where this method is used, the total payments must be distributed to shares, loan principal and interest, etc., for entry into the Journal and Cash

Record and for posting into the individual accounts. The information needed for the distribution may be obtained from the individual accounts in the course of posting them. When posting or electronic data processing furnishes the distribution totals, they may be used for entry in the Journal and Cash Record. However, when the individual accounts are hand posted or when the accounting machine is not capable of furnishing the necessary totals, the distribution ordinarily will be shown on the individual vouchers. The vouchers should then be totaled to furnish the entries for the Journal and Cash Record.

In the event that the breakdown of Shares, Loans, Interest, etc., is not developed in time to provide the credit entries for the total payments, the amount of the total payments should be credited to "Accounts Payable, Undistributed Payments". When the breakdown of the total payments has been determined, the amount in Account Payable, Undistributed Payments should be cleared by debiting that account and crediting Shares, Loans, Interest, etc.

Since the benefits of the total payment plan will be derived only if used in conjunction with a total payment receipt or a total payment passbook, a statement of account must be furnished to the members.

On either the front or back cover of the total payment passbook, there should be printed, an explanation of the total payment procedure including an indication to the member that he will receive a statement of account showing all his share and loan balances and a detailed breakdown of the credits to his accounts.

Mail Receipts

When Passbooks are Used

Postings to the passbook represent the member's official record of transactions. Therefore, the credit union should require the members to submit the passbooks with mail payments so that the proper postings can be made upon receipt and the passbooks can be promptly returned to the members. If any mail payments are received without the passbooks, the credit union should mail back temporary receipts accompanied by instructions to mail or

bring in the passbooks so that they can be brought up to date.

For members who mail in their payments, the credit union may arrange to return their passbooks to them in a special envelope, enclosed in which there would also be a Cash Received Voucher for the next payment. If the envelope has a window opening and the member's name and current address is so positioned on the passbook, the need for addressing the envelope to the member will be eliminated.

Enclosing a return envelope, pre-addressed to the credit union, with the passbook will also facilitate payment. A variation of the plan discussed above would be to use an ordinary window envelope to return the passbook to the member, enclosing a pre-addressed return envelope on the flap of which the Cash Received Voucher is printed.

When Statements of Account Are Used

Under all circumstances, members should receive a receipt for his/her payment. However, when a statement of account plan is used, the member's official permanent record for transactions shall be the statement of account. The member will thus be able to compare the payments shown on his/her periodic statement of account with his/her canceled checks, money order stubs, or other evidence of his payments that he/she retained after the payments were made. The board of directors could decide to eliminate receipts when mail payments are made by check or money order. For the proper protection of the members and the credit union, receipts should be mailed to any member who sends cash (coin or currency) through the mail even when a statement of account plan is used. Because of the hazards involved, the credit union should discourage sending cash through the mail.

Due to the nature of mail receipts, credit union management must ensure that proper internal controls are established for the handling of mail receipts, i.e., opening mail receipts under dual control, posting receipts separately by teller number, etc.

Coupon Book Plans for Loan Repayments

A coupon book method for loan and interest repayments has the advantage of eliminating the need for preparation of Cash Received Vouchers and the calculation of interest at the window when loan payments are made on schedule. Furthermore, since coupon books are feasible only when the interest and loan are set up on a level-payment plan, the exact amount due from the member at each payment date is known. Coupon books are advantageous to those credit unions where a large proportion of the membership pays its loans by mail.

The amount of the payments and the member's account number may be perforated through all the coupons in a book by means of a perforating machine. The coupons are pre-numbered consecutively as to payment number, beginning with No. 1 for the first payment. Coupon books may be prepared with any number of coupons to be used with loans of varying maturities.

In addition to showing the amount of the payment and identification of the member, the coupon must show the due date. It should also provide space for the member to show the distribution of any payments made in addition to those shown on the pre-recorded portion of the coupon - such as payments to shares. The coupon can be so designed that it will serve as an effective Cash Received Voucher, thereby eliminating the need for the credit union to prepare a voucher when each coupon is received. The date on the voucher portion of each coupon or on the separate Cash Received Voucher should be the date of receipt of the funds by the credit union.

The front or back cover of the coupon book may be used for instructions to the member in making payments or such instructions may be printed on the face of each coupon.

In using a coupon book plan the board of directors may adopt a grace period following the due date of each payment in order to ease the task of computing interest.

Balancing Teller's Cash Receipts and Disbursements using Online Computer Terminals

The following procedures or their equivalent should be used by each teller in balancing his/her assigned funds:

- a) Obtain computer terminal Teller Totals for the day's transactions.
- b) Keep all miscellaneous receipts, both vouchers and money, separate from share and loan receipts.
- c) Prepare adding machine tape of all checks, share drafts and money orders, etc., in the cash drawer that were received.
- d) Count the cash.
- e) Compare total of checks and cash to the ending balance of the Teller Totals.
- f) Prepare adding machine tape of all check disbursement vouchers.
- g) Compare the tape total to the total amount of checks issued.
- h) Determine that any cash over or short amounts are recorded. Adjust the ending cash balance, if applicable.
- i) After balancing has been accomplished, the head teller should clear the teller terminal totals.

When the above procedures are followed, the teller's cash on hand should balance to the appropriate computer totals. The cashier, after receiving all funds from the tellers, should prepare the Cashier's Daily Summary (or its equivalent). Modifications in this form may be required, as determined by the particular computer system being used.

Receipts and Disbursements using Automatic Transfer Accounts and NOW Accounts

With the passage of the Depository Institution Deregulation and Monetary Control Act of 1980, banks and savings and loans were given the authori-

ty to offer Automatic Transfer Accounts and Negotiable Order of Withdrawal Accounts (NOW), respectively. Federal credit unions may use these accounts for disbursing credit union funds as long as the account is with an institution which meets the criteria of Section 107(7) or (8) of the Federal Credit Union Act. Since this account is similar to a checking account, it can be used in place of a regular checking account by the credit union. Before a decision is made to use one of these accounts, the board of directors must assure themselves that it will be in the credit union's best interest. The board should review the cost involved and the effects it will have on the credit union operation. These accounts have some of the same features as a share draft account in that the account earns interest/dividends and that the checks/drafts are usually truncated (meaning the canceled checks/drafts might not be returned to the credit union).

If the checks/drafts are truncated, the credit union must be sure that it will be able to obtain a copy of the canceled check or draft. Furthermore, although these accounts will earn interest/dividends, many of the programs developed have service charges which are not associated with a regular checking account. Requirements imposed on these accounts differ widely among financial institutions; therefore, the board should study several programs before making a final decision.

Procedures for Cash Disbursements/Check Register

A savings of time and effort may be realized by the use of a check register. A check register is a record used to record individual checks drawn. The information from the check register is totaled each day and entered in summary entry form in the Journal and Cash Record. Beginning and ending check numbers and note numbers should be shown in the appropriate columns.

A check register should provide the following minimum information to insure proper internal controls:

- Date of payment:
- Name of the payee;

- Account number of the member, when applicable;
- Check number in numerical sequence;
- Note number, if applicable;
- Amount of the disbursement;
- Purpose of the disbursement; and
- Amounts extended to the respective General Ledger Account(s).

Journal Vouchers designed or adapted to provide the above minimum items of information can be used as a check register. Two other types of commonly used check registers are discussed below.

Listed Check Register

A check register may show a listing of each individual check on a form designed to fit the credit union's needs, but care should be exercised to include at least the minimum information listed above. The purpose of the disbursement can be shown in columnar form with the columnar headings designating the purpose, such as a column headed "Shares" in which the amounts of share withdrawals are shown on the horizontal line with the appropriate check number and other information.

When accounting machines are being used, the machine by-product (proof sheet, journal sheet, etc.) may be used as a check register. The information that is typed on the check is reproduced on the machine by-product. Other minimum information is typed directly on the machine by-product.

As a means of eliminating the use of Journal Vouchers, or its equivalent disbursement vouchers, with a listed check register, additional columns can be provided for showing information that appears on the voucher form, such as approval or authorization for the disbursement, and acknowledgment of receipt of the check by the member, if applicable, and the related journal entry.

Voucher Check Register

In a voucher check arrangement, the check and one or two copies are prepared simultaneously. These copies can serve as a journal voucher and/or as a check register. Under the voucher check arrange-

ment, the check is given to the payee, and the copy(ies) are retained by the credit union.

Either a duplicate or triplicate voucher arrangement is acceptable. Under a triplicate system, the first copies are sorted into account number order for posting to the member's accounts. A Journal Voucher (or its equivalent) should be attached to these copies, summarizing the transactions for the entry of the day's disbursements in the Journal and Cash Record, thus eliminating the necessity of entering each check individually. The last copies of the checks are sorted in check number order and become the check register. If a duplicate voucher check arrangement is used, only one copy of the check is prepared. These copies are first sorted in account number order for posting to the members' accounts. After the posting is accomplished, the copies should be sorted in check number order to become a check register. The summary voucher for that day's disbursements should be attached to the copy of the first or last check number written for the day.

The copies of the voucher checks must provide space for all of the information needed for journal vouchers. Space will also be provided for the note number. The check register copies will need to provide the minimum information needed for check registers as outlined above.

Voucher checks will usually be obtained in loose form; therefore, extra care must be exercised in storing these because the loss of these checks may not be noticed as readily as when bound books are used. All unused voucher check stock must be placed under the control of one employee. This employee will be responsible for determining that all usage is accounted for, by check numbers on a daily basis.

Voucher check forms will be designed to meet the needs of the credit union. To maintain the confidential relationship required by the Federal Credit Union Bylaws, the purpose of the disbursement must not appear either on the face or reverse side of the check.

Disbursing Share Withdrawals and Loans in Cash

Generally, federal credit unions find that they can operate efficiently making disbursements for share withdrawals and loans by check. However, when the volume of checks issued for these purposes becomes burdensome, the board of directors may want to authorize the payment of either share withdrawals or loans, or both, in cash. In its authorization, the board should set a limit on the amount of cash that may be disbursed with each transaction.

Making payments in cash will undoubtedly increase the credit union's change fund needs. When authorizing disbursements in cash, the directors should also consider whether the size of the change fund needs to be increased and whether surety bond coverage is adequate (refer to Section 713.5 of the *National Credit Union Administration Rules and Regulations*) and authorize any necessary adjustments.

Disbursements in cash should be made to members and joint owners only in person, and only for the purposes and within the conditions stipulated by the board. Forms used for disbursing cash to members may not serve as authorization for payments to third parties. Disbursements in cash may be made for share and loan transactions only and may not be extended to other types of disbursements, except for disbursements out of Petty Cash. If the credit union is an authorized agent for the redemption of U. S. Savings Bonds, the board may authorize redemption of the bonds in cash in accordance with the procedures outlined in this manual.

The Journal Voucher forms used for disbursements by check are usually not suitable for disbursements in cash. The significant features of a form to be used for disbursements in cash are: (1) the form must provide information about the transaction so that it may be used as a source document to support the entry in the Journal and Cash Record and the posting to the member's ledger, (2) the form must provide space so that it may serve as a receipt, or acknowledgment, from the member signifying that he has received the cash, and (3) the form must provide space for the signature or identification of the person making the disbursement. If a credit union

disburses both shares and loans in cash, it may design a combined form for this purpose.

It is preferable for control purposes that separate forms be used for disbursements in cash and disbursements by check. However, if it is desired that one form be used to accomplish both purposes, the form must provide space for clear identification of whether the disbursement was made by cash or by check, the check number, the signatures of the person who paid the cash, and the person who received the cash, as well as the other information about the transaction so that the voucher can serve as a source document.

Effective control must be established for disbursements in cash. For example, when shares have been pledged as security for a loan, procedures must be established to prevent the disbursement of the pledged shares. Before cash is disbursed as loan proceeds, the disbursing official or employee must make certain that all of the required loan papers are properly completed including: an approved loan application; a note signed by the borrower and all the required co-makers; and all completed and secured collateral and security documents.

The following are accounting procedures for disbursing share withdrawals and loans in cash. The cash disbursement forms should be totaled daily and a summary prepared on a Journal Voucher, or its equivalent. From this summary voucher a summary entry should be made daily in the Journal and Cash Record to reflect the debits to Shares and Loans. The corresponding credit will be to Cash and should represent the check drawn to replenish the change fund for the disbursements in cash for the day. The number of the check issued to replenish the change fund must be entered on the summary Journal Voucher. If summary entries for disbursements by check are made in the Journal and Cash Record, the check issued to replenish the change fund will be included in the summary entry.

If the checks are entered individually in the Journal and Cash Record, the entry therein for the disbursements in cash will reflect the issuance of the check for the change fund replenishment.

Postings to the member's ledgers should be made from the cash disbursement forms. These forms and the summary Journal Voucher should be retained in the same manner as other source documents.

Check Signing Machines

If a large volume of checks are issued, the use of a check-signing machine may be warranted. Desirable safeguards in using a check-signing machine are that:

- a) The plate bearing the signer's facsimile signature needs to be used under his/her exclusive control at all times.
- b) The signer whose plate is being used in the machine should be present at the time his/her signature is being impressed on checks.

Circumstances may be such that a credit union may not be able to arrange for use of a check-signing machine with the signature plate of an authorized employee or official who will always be in a position to control his/her signature plate or be present when his plate is being used. Under such circumstances, the following safeguards should be established:

- c) The board of directors and the official or employee whose signature plate is being used in his/her absence should authorize certain other persons to use such plate.
- d) The board of directors should determine that the individual whose signature plate is being used in his absence recognizes and takes full responsibility for all checks issued with his/her signature on them.
- e) The board of directors should ensure that the following controls are established and maintained to protect against improper use of the machine:

- 1) The check-signing machine should have a counter to record or count each check inserted for signature, and this counter device should be under lock with the key in the possession of

someone other than those who operate the machine.

2) A register or control record should be maintained which will show the check number, the date and initials or signature of the person who operated the machine. If numerous checks are signed at one time, and since checks are issued in straight numerical sequence, only the number of the first and last checks so processed need be listed in the register, or control record, along with the date and initials or signature.

3) The number shown on the counter device on the machine should be entered at the end of each day in the register or control record. The number of checks issued for the day as shown by the counter device will thus correspond with the number of checks listed in the register or control record. Any discrepancies in such numbers must be accounted for or explained in the register or control record.

Check Protectors

Machines which will indelibly imprint the amount of the check, commonly known as "check protectors," are also available. In some versions, these machines are equipped with registers which accumulate the number and amount of checks processed through the machine. It is possible to obtain a combination check signing and protecting machine in a single unit.

Check Writing Machines

Various computing equipment which will write the complete check are available. These machines are usually programmed to operate independently or to produce a computer-generated output. They will perform certain or all functions in writing a check with minimal input from a teller or other employee. At least the following controls must be established and maintained in order to protect against improper machine usage:

a) The check-writing machine should have a counter to record or count each check written. This

counter device shall be under lock with the key in the possession of someone other than those who operate the machine.

b) A register or control record should be maintained (some machines prepare this at the time the check is written) which will show the date and initials or other identifying symbol of the person who used the machine.

c) Daily balancing of the number of checks written to the number of blank checks used should be performed.

d) The surety company should be notified of the proposed machine usage in order that surety can indicate whether full bond coverage will continue in force.

e) If the check-writing machine also signs checks, the control procedures for the signature plate, as discussed under check-signing machines, should be followed.

Loan Drafts

A draft, sometimes referred to as a bill of exchange, may be defined as follows:

A draft is a formal written order directing the payment of money by a specified party to another party, who may or may not be the maker or drawer of the instrument.

Relating the above definition to a draft transaction as it might be handled by a credit union, the maker or drawer of the draft instrument would be the credit union itself. The draft will ordinarily be made out to either the member or to a vendor such as an automobile dealer from whom the member desires to purchase some goods to be paid for by the proceeds of the draft. The "specified party" is the credit union's bank since the draft is actually drawn upon it.

There are many different types of drafts, or bills of exchange, all of which serve a definite purpose under certain conditions or circumstances. A common type is a check. An important feature of the type of draft generally used by credit unions, which is also

true of most types of drafts or bills of exchange, is that the instrument must be honored or accepted by the party upon whom it is drawn.

There may be diversification of the use of draft procedures by federal credit unions. There are many complexities involved in the effective use of drafts. Generally these complexities develop because of local laws and customs. As a result, a credit union must be certain that it is equipped to legally and effectively carry out the responsibilities connected with the use of drafts.

Some credit unions may find that the use of drafts facilitates loan transactions with its members, especially with members located at a point distant from the credit union. Drafts can be used by credit unions in connection with any loan transaction, but they are perhaps most commonly used with automobile loans.

Liability in Connection with Loan Drafts

An important question arises as to whether the credit union incurs a liability at the time authorization is issued for a draft to be drawn upon it, or whether no liability exists until the draft is accepted. A number of factors influence the answer to this question since these factors are of a legal nature, based upon the nature of the draft documents and procedures, and since these factors will vary in different jurisdictions, the credit union must be guided by the advice of its attorney in determining whether it incurs a liability upon authorization of a draft.

If it is determined that the credit union incurs a liability when a draft is authorized, "Accounts Payable-Drafts Authorized", should be credited for the amount authorized. This account should be debited when the draft is paid by check, or when the authorization is voided.

Drafts issued by the credit union which have not been presented for payment after a reasonable period has elapsed (90 days or more) should be transferred to "Accounts Payable." The following entry should be used to transfer those old drafts:

Dr.-Accounts Payable - Drafts
Authorized
Cr.-Accounts Payable

If the credit union determines that it has no actual liability until the draft is accepted, it may then have a contingent liability upon authorization of a draft to be drawn. In either case, the authorized draft must be disclosed on the credit union's financial statements in order to permit valid analysis of the credit union's financial condition. Accordingly, the disclosure should be shown on the Statement of Financial Condition as a note, to read as follows:

As of (Date) _____, the credit union has authorized drafts to be drawn upon it in the amount of \$ _____ which have not been presented for acceptance.

Records in Connection with Loan Draft Procedures

Management of the credit union has a definite responsibility to prepare and maintain complete and accurate records of draft transactions. Draft authorization copies and other papers relating to the transaction should be filed in a separate folder for each transaction until the draft is accepted and paid. This will provide a greater measure of control over the outstanding items than if the papers were filed in the normal fashion.

Further control over outstanding draft authorizations will be provided by a draft register or daily record of draft transactions. The draft register should be in columnar form and provide information necessary for control over the operation, depending on the nature of the credit union's procedure. Suggested columnar headings are listed below:

- a) Date authorized. (This should also be the date of entry in the draft register.)
- b) Draft number or authorization number. If the credit union furnishes the draft instruments to the potential drawers of the drafts, the draft in-

struments should be numbered consecutively in the same manner as checks are numbered. The draft authorizations should be similarly numbered. The best control would be achieved if the draft form and the draft authorization for the same transaction bore the same number.

- c) Name. The drawer's name should be shown. If the drawer is an individual, such as an automobile vendor, other than the member involved in the transaction, both his name and the member's name should be shown in this column.
- d) Account number of the member.
- e) Amount authorized.
- f) Date paid. (Date the draft is paid by the credit union.)
- g) Check number of check used to pay the credit union's bank.
- h) Date voided, if such occurs.
- i) Reason for voiding.

Amounts shown in column e. above, which are not followed by entries in columns f. and g., represent the outstanding draft authorizations. The total of these amounts can be checked against the total of the outstanding authorizations, copies of which should be filed in separate folders as indicated above. The register can serve as a subsidiary to the General Ledger control, "Accounts Payable-Drafts Authorized", and the total of the outstanding authorization (open amounts in column e.) should agree with the balance in that account. Likewise, the total of the open amounts in column e. will be the amount of any contingent liability, if applicable.

Responsibility for Funds on Hand to Meet Loan Draft Obligations

Credit union management has a very profound responsibility in connection with draft procedures to assure that the credit union has funds on hand to meet the total amount of cash required for drafts authorized. A credit union maintaining a draft register similar to the one described above will have no difficulty in determining on a current basis the amount of funds needed to satisfy obligations for drafts authorized.

Sale and Redemption of U.S. Savings Bonds

This account should reflect the balance of cash on deposit in a separate bank account established by the credit union for installment payments received on U.S. Savings Bonds.

Section 121 of the Federal Credit Union Act provides that federal credit unions may act as agents for the U.S. Treasury Department for the sale of U.S. Treasury Bonds and Notes. Only those credit unions that have applied to the U.S. Treasury and have been approved as issuing and/or payment agents may engage in savings bonds and savings note transactions. Both members and nonmembers can participate in these transactions.

When installment payments are received from purchases of U.S. Savings Bonds or Notes, "Cash" should be debited and "Accounts Payable-Installment Payments on U.S. Bonds", should be credited. When sufficient funds are available for the issuance of a bond for any purchaser or purchasers, the bonds should be issued and liability for installments received should be eliminated by debiting the payable account for the purchase price of the bonds and crediting "Accounts Payable-U.S. Savings Bond Remittances".

Illustrative Entries

- a) To record receipts of installment purchases of U.S. Savings Bonds:

Dr.- Cash - U.S. Bond Installment Payments	\$122.50
Cr.- Accounts Payable- Installment Payment on U.S. Bonds	\$122.50

b) To record the issuance of a fully-paid bond:

Dr.- Accounts Payable- Installment Payment on U.S. Bonds	\$150.00
Cr.- Accounts Payable - U.S. Savings Bond Remittances	\$150.00

c) To record the cancellation of a bond authorization and pay the subscriber the balance of the installment contract:

Dr.- Accounts Payable - Installment Payment on U.S. Bonds	\$12.50
Cr.- Cash-U.S. Bond Installment	\$12.50

d) To record remittance made to the Federal Reserve Bank for bonds issued under the installment payment plan:

Dr.- Accounts Payable-U.S. Savings Bond Remittances	\$150.00
Cr.- Cash	\$150.00

Detailed Transactions

Debit:

a) With cash received representing payments of installments on the purchase of U.S. Savings Bonds.

Credit:

a) With withdrawals by purchaser of deposits made for the purchase of U.S. Savings Bonds.

b) With remittances to the Federal Reserve Bank to cover the cost of bonds issued to installment purchasers.

Bond Sale Transactions/Records

Federal credit unions must properly account for the receipt, sale, and remittance of the proceeds of all bonds sold and for all bonds redeemed.

Federal credit unions engaged in U.S. Savings Bonds transactions will be dealing with both the U.S. Treasury Department and the regional Federal Reserve Bank. Pertinent instructions from both agencies will need to be followed. Adequate safe-keeping facilities for the stock of unissued bonds must be provided.

The invoices received from the Federal Reserve Bank may be used as a record of the U.S. Savings Bonds received. The bonds received should be compared with these invoices for correctness of quantity, serial numbers, and denominations. A record of the serial numbers and denominations of spoiled bonds returned to the Federal Reserve Bank must be attached to the advices received from the Federal Reserve Bank acknowledging the receipt of the spoiled bonds. Both the invoices and the advices must be retained as a part of the records of the credit union.

The accounting discussion and illustrations below refer to the use of two accounts: (1) "Accounts Payable, U.S. Savings Bonds Remittances", which is for use in recording the liability where the full purchase price has been received and bonds issued, but funds have not yet been remitted to the Federal Reserve Bank; and (2) Accounts Payable, Installment Payments on U.S. Bonds, to record the installment payments received toward the purchase of bonds, where the full purchase price has not yet been received and/or the bonds have not been issued.

Separate accounts may be established for each type of bonds purchased. It is essential that accurate subsidiary records be kept to support the individual purchases or installment payments made by each individual and the bonds issued to these individuals.

Cash Received from Sales of U.S. Savings Bonds

A Treasury Department form "Application for United States Savings Bonds" which is furnished by the Federal Reserve Bank, should be used to record cash received from each sale of bonds, and this form may be used in place of the Cash Received Voucher if desired.

A form titled, "Record of Cash Received from Sales of U.S. Savings Bonds," provides a memorandum record of each savings bond sold. It also serves as a detailed record in support of the credit balance of "Accounts Payable-U.S. Savings Bond Remittances". This account will reflect the liability of the credit union as an issuing agent for the proceeds received from sales of U.S. Savings Bonds. The credit balance of the account represents the total amount received from sales of bonds which have been issued but on which the funds have not been remitted to the Federal Reserve Bank.

The copy of the registration stub may be used as a substitute for the form titled "Record of Cash Received from Sale of U.S. Savings Bonds", provided that such stubs are filed in a manner which will provide adequate information to prove the credit union's accountability for bonds received and that all cash for bonds sold has been remitted to the Federal Reserve Bank.

The total of the amounts received, as shown on the "Record of Cash Received from Sale of U.S. Savings Bonds" form or by the unremitted registration stubs (amounts received from sales of bonds issued but which have not been remitted to the Federal Reserve Bank), should equal the credit balance of "Accounts Payable-U.S. Savings Bond Remittances". The total of these amounts should be proved with the balance of this account at the close of each month in the same manner as the Individual Share and Loan Ledger accounts are proved with their control accounts in the General Ledger. The monthly lists of these amounts should be retained.

If a credit union desires to develop its own record of U.S. Savings Bonds sold, the record should contain the following minimum information:

- Date of receipt of cash.
- Name of purchaser.
- Maturity value of bond and bond serial number.
- Amount of proceeds received from each purchaser.
- Date proceeds remitted to Federal Reserve Bank.

Illustrative Entries

a) When the daily total of cash received from sales of fully purchased and issued savings bonds is entered in the Journal and Cash Record (see section titled "Installment Payments" below for installment purchases of savings bonds):

Dr.- Cash	\$75.00
Cr.- Accounts Payable - U.S. Savings Bonds Remittances	\$75.00

b) When proceeds received from sales of savings bonds are remitted to the Federal Reserve Bank:

Dr.- Accounts Payable - U.S. Savings Bonds Remittances	\$75.00
Cr.- Cash	\$75.00

Payments Received

As a posting medium for entries in the individual accounts and in the Journal and Cash Record, either payroll deduction forms or cash received vouchers may be used. In those credit unions that receive installment payments through payroll deductions, provision may be made on the records already in use to show the deductions applicable toward the purchase of bonds.

Cash received vouchers bearing an appropriate notation of the nature of the collection should be prepared when installment payments are received in cash. If a separate cash account is used for bond installment payments received, the appropriate Cash account column should be used to record the entry in the Journal and Cash Record.

Installment Payments Received over the Counter

Those credit unions collecting installment payments in cash over the counter should provide a receipt for each payment received. The form of receipt may be a duplicate cash received voucher. An installment payment record folder can also be prepared for recording the payments. If memorandum entries have been made in the folder, a notation should be made therein of the date the bond was issued and the amount thereof. If receipts have been given for the installment payments, they should be turned over to the credit union when the bond is issued.

The record of deductions from salaries or wages as furnished by the company to its employees may be regarded as sufficient receipt until such time as the bond is issued.

The credit union should be prepared to furnish any subscriber a statement of installment payments received, if one is requested.

Disbursements

The disbursements should be made by check and should be limited to remittances for bonds issued and to withdrawals by subscribers of installments paid. A person should only be permitted to withdraw these payments prior to their reaching the amount agreed upon for the issuance of a bond, and only then upon termination of employment or the cancellation of the authorization for purchase of bonds either by the person or the credit union. In such an event, the amount of the accumulated payments may be returned and the individual account closed. A receipt should be obtained from the person receiving the accumulated funds. A Journal Voucher may be used for this purpose. This credit union should also obtain for its files a release from

the subscribers when authorizations for payroll deductions applicable to bond purchases are canceled.

Liability Account

"Accounts Payable-Installment Payments on U.S. Bonds" should show the liability of the credit union for installment payments received for application toward the purchase of U.S. Savings Bonds. The credit balance of the account should represent the total of such payments received and not yet applied to the purchase of bonds.

The installment payments on U.S. Savings Bonds are not the equivalent of payments on shares and no interest or dividends will be paid thereon. Furthermore, these payments are not to be considered as security for loans and the approval of the credit committee or loan officer for withdrawals is not necessary. This account will be credited with the total of cash received as installment payments on U.S. Savings Bonds as shown by cash summary vouchers or payroll deductions records.

Bonds are issued whenever the installment payments by a subscriber or group of subscribers reach the designated purchase price. Upon issuance of bonds, this account should be debited with the total amount of the sale and "Accounts Payable U.S. Savings Bonds Remittances", should be credited. Entries for bonds issued should also be made in the Record of Cash Received from Sales of U. S. Savings Bonds.

Records of Installment Payments

Credit unions that receive installment payments on bonds through payroll deductions should obtain from the subscribers an authorization for such deductions and for application thereof to the purchase of bonds. The authorization should be addressed to both the employer and the credit union.

The U.S. Treasury issues a standard card form, Payroll Authorization for Purchase of Savings Bonds, which may be used in this connection. Certain changes in the form are necessary to include the credit union as a party to the agreement.

Credit unions receiving installment payments direct from subscribers should, likewise, have an authorization for application of the payments to the purchase of bonds. The U.S. Treasury form will be of assistance in preparing the authorization.

Subsidiary ledgers

Subsidiary ledgers should be established to account for the installment payments received from each person. The individual accounts for installment payment will ordinarily be sold separately from the Individual Share and Loan Ledgers. Postings from the payroll deduction records or cash received vouchers to the individual installment accounts should be made in the same manner as postings to the Individual Share and Loan Ledgers. The individual installment account balances should be totaled at least at the end of each month and balanced with the total shown in General Ledger "Accounts Payable-Installment Payments on U.S. Bonds". The monthly trial balance tapes of the individual accounts should be kept for audit purposes. The ledger forms used should provide the following information:

- Name and address of subscriber.
- Date and amount of payments received.
- Date and amount of withdrawals or amounts applied to issuance of bonds.
- Balance to credit of subscriber.

Savings Bond Redemption Transactions

Credit unions, as paying agents, may redeem savings bonds by check, cash, or by crediting the member's share account. Amounts receivable from the Federal Reserve Bank for such redemptions should be charged to "Accounts Receivable-U.S. Savings Bonds Redeemed".

Payment by Check

Debits to "Accounts Receivable-U.S. Savings Bonds Redeemed", should be made when checks are issued in payment of bonds. Credits should be made when a remittance is received from the Federal Reserve Bank for the value of the various shipments of bonds.

If it is anticipated that bond payments will be handled in volume, or if a volume of such transactions develops, blank columns of the Journal and Cash Record may be used to record the debits and credits of Accounts Receivable - U.S. Savings Bonds Redeemed.

A Journal Voucher should be prepared in connection with each payment of a bond(s) by check. This voucher should show the usual information and, in addition, should show the serial number of the bond(s) paid.

Illustrative Entries

- a) When a check is issued in payment of a savings bond of \$50 denomination and having a current redemption value of \$25:

Dr.- Accounts Payable - U.S.	
Savings Bonds Redeemed	\$25.00
Cr.- Cash	\$25.00

- b) When a remittance is received from the Federal Reserve Bank for the value of paid bonds and notes shipped:

Dr.- Cash	\$175.00
Cr.- Accounts Receivable - U.S.	
Savings Bonds Redeemed	\$175.00

Payment by Share Credit

A Journal Voucher should be used to record the redemption of a bond(s) by share credit. This voucher should show the usual information and, in addition, show the serial number of the bond(s) paid. All such Journal Vouchers involving share credits for

the redemptions may be combined daily on a summary voucher for entry into the Journal and Cash Record.

"Accounts Receivable-U.S. Savings Bonds Redeemed", should be debited for the value of any bonds paid by credit to shares. Posting of the share credit should be made to the member's Individual Share Ledger. Valuable information about savings bonds and savings bonds redemption values can be obtained at www.savingsbonds.gov.

Illustrative Entry

To record payment by the credit union of a savings bond of \$50 denomination and having a current redemption value of \$25, by crediting the member's share account:

Dr.- Accounts Receivable - U.S. Savings Bonds Redeemed	\$25.00	
Cr.- Shares		\$25.00

Payment in Cash

Payment of bonds may be made in cash if the board of directors of the credit union desires to do so. If the board decides to make these disbursements in cash, it may, by recorded resolution, exercise this option of the standard bylaws.

A journal voucher should be prepared, indicating among other things the person to whom the funds were paid, the amount paid, and the serial number of the bond(s). The fact that the disbursement was made in cash should also be noted and the payee should sign the voucher in the usual manner. The journal voucher should be held with the bond pending its withdrawal from the change fund. The journal vouchers attached to the bonds withdrawn from the change fund should be detached and summarized to support the entry in the Journal and Cash Record to replenish the change fund.

Illustrative Entry

To record check drawn in replenishment of change fund for bonds paid in cash:

Dr.- Accounts Receivable - U.S. Savings Bonds Redeemed	\$381.00
Cr.- Cash	\$381.00

Recording Payment Data

Credit unions will be required to record certain payment information on the face of bonds paid. Among the required items are the amount paid, the paying agent's name, the date of payment, and who approved or made payment. The method of payment, such as cash or check (include check no.), share credit and any other pertinent information can be noted on the back of the bond.

Shipment of Paid Bonds

Shipment of paid bonds to the Federal Reserve Bank should be supported by letters of transmittal in accordance with instructions from the bank. It will be preferable for purposes of identification and balancing of accounts to have the shipments include all bonds paid on one or more business days.

The debit balance in "Accounts Receivable-U.S. Savings Bonds Redeemed", at any given date should represent that total value of redeemed bonds on hand plus the value of bonds shipped to the Federal Reserve Bank for which remittance has not been received.

Copies of letters transmitting shipments of bonds should be retained and filed. One file should include copies of letters on shipments for which remittance has been received and another file should include letters covering shipments for which payment has not been made by the bank. The file on shipments not paid for and the redeemed bonds on hand pending shipment will constitute the support for the General Ledger Account, Accounts Receivable - U.S. Savings Bonds Redeemed.

Compensation for Services

The compensation received by the credit union for serving as a paying agent should be credited to "Other Operating Income". This credit should be made at the time the remittance is received.

CASH EQUIVALENTS

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 insignificant risk of changes in value because of changes in interest rates.

For purposes of this section, generally, only investments with original maturities of three (3) months or less qualify as a cash equivalent.

Examples of items commonly considered to be cash equivalents are Fed funds sold, treasury bills, commercial paper, money market funds, certificates of deposit (3 months or less maturity), and other highly liquid investments in banks, S&L's, and corporate credit unions.

Note: The treatment of cash equivalents in the Statement of Cash flows may differ from the classification used here in the Statement of Financial condition.

Federal Funds Sold

A sale of Federal Funds occurs when a Federal credit union transfers immediately available funds to a bank and the bank agrees to repay the funds to the Federal credit union one or more business days later. The funds may be transferred to the bank by any method, including from an account maintained at the bank by the credit union. The agreement to repay may have a specific maturity date or may be open-ended. The funds are unsecured and are generally loaned overnight (or over a weekend) at the market rate for Federal Funds transactions. Federal fund investments generally represent very liquid funds, and the credit union is able to require repayment at anytime. An open-ended agreement has no specific maturity date. It requires, however, repayment on

any date that is specified by either the Federal credit union or the bank. A sale is considered as a deposit which can be made in accordance with Section 107(8) of the Act.

General Comments

In order that sales of Federal Funds are conducted in a safe and sound manner: (1) the credit union itself should transfer the funds to the bank; and (2) consideration should not be received from a third party. A Federal funds transaction is not subject to Regulation Q limitations or to the Regulation D reserve requirements.

Accounting Entries

A sale of Federal Funds will be recorded as a deposit in "Other Investments", which is a debit balance account.

a) To record investments in Fed funds:

Dr.-Other Investments	\$80,000	
Cr.- Cash		\$80,000

b) To record the sale of Fed funds:

Dr.- Cash	\$80,000	
Cr.- Other Investments		\$80,000

Treasury Bills

Represent short-term (3 months or less) U.S. Government obligations. For accounting discussion and examples, refer to the Investment section.

Commercial Paper

Represents short-term (3 months or less) corporate obligations that is unsecured and should be highly rated by top rated entities including Standard & Poors, Moody's, etc.

Accounting Considerations

Interest expense for the issuer and income for the investor are based on the coupon, if issued at face

value, or accretion of the discount, if issued at a discount.

Shares/Deposits/Certificates in Commercial Banks, S&L's, Savings Banks

For purposes of this section, this represents investments at these type institutions that have an original maturity of 3 months or less. For more detailed accounting procedures, refer to this area in the Investment section.

Shares/Deposits/Certificates in Corporate Credit Unions

For purposes of this section, this represents investments at corporate credit unions that have an original maturity of 3 months or less. For more detailed accounting procedures, refer to this area in the Investment section.

Certificates of Deposit

A certificate of deposit represents a short-term debt obligation issued by a bank, thrift, credit union, etc. For purposes of this section, certificate of deposits with an original maturity of 3 months or less qualify as a cash equivalent.

Accounting Considerations

Interest expense for the issuer and income for the investor are based on the coupon if issued at face or accretion of the discount if issued at a discount.

All Other Investments

For purposes of this section, this represents investments at "Other Credit Unions" that have an original maturity of 3 months or less. For more detailed accounting procedures, refer to this area in the Investment section.

Traveler's Checks/Money Orders

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

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INVESTMENTS

This section discusses investments and accounting for investments. In general, investments are limited to those authorized by Section 107 of the Federal Credit Union Act (the Act) and Part 703 of the National Credit Union Administration Rules and Regulations. Rather than repeat the section and part here, we refer you to the above referenced documents for examples of the types of investments permissible for federal credit unions.

SECURITIES

Generally accepted accounting principles (GAAP) defines a security as a

“share, participation, or other interest in property or in an enterprise of the issuer or an

obligation of the issuer that (a) either is represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer, (b) is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment, and (c) either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.”

When securities are acquired, a credit union must assess its intent and ability and assign its debt and equity securities to the appropriate measurement category: *trading*, *held-to-maturity*, or *available-for-sale*. Securities not classified as *trading*, and not

meeting the requirements of *held-to-maturity* shall be classified as *available-for-sale* (AFS). Not less frequently than the end of each dividend period, (i.e., monthly, quarterly, semi-annually, or annually), the appropriateness of the classifications, and the reasonableness and accuracy of the related fair value measurement (*trading* and *available-for-sale*), shall be assessed.

Reporting requirements shall be as follows:

- *Debt and equity* securities that are bought and held principally for the purpose of selling them in the near term shall be classified as *trading securities* and reported at fair value through the income statement.
- *Debt* securities (not equity) that the enterprise has the positive intent and ability to hold to maturity shall be classified as securities *held-to-maturity* and reported at amortized cost.
- *Debt and equity* securities not classified as either securities *trading* or *held-to-maturity* securities shall be classified as securities *available-for-sale* and reported at fair value through a separate component of equity in the balance sheet, *Accumulated Unrealized Gains/Losses on Available-for-Sale Securities*.

A credit union shall consider GAAP in how it plans to manage its holdings of securities when designating individual securities as *trading*, *held-to-maturity* or *available-for-sale*. Credit unions which use an outside independent accountant are encouraged to consult them when assigning their securities to the measurement categories. There is no specified percentage or amount of securities that a credit union must assign to each category. Rather, the amount of securities a credit union assigns to each of the three categories depends on the facts and circumstances surrounding the credit union and the actual securities it owns.

A credit union shall have adequate documentation to support the initial assignment of securities to the three categories, the assignments made when securities are purchased, and the periodic evaluations (not less frequently than the end of each dividend period) of the continuing appropriateness of these assignments. The amount and types of documentation to support

the assignment of securities to the measurement categories will vary from credit union to credit union based on its size and the complexity of its operations, including the nature and scope of its securities activities. A credit union's documentation may include its:

- Written and approved investment policies and strategies,
- Policies governing liquidity and funds management and interest rate risk management,
- Board or committee minutes,
- Budgets,
- Cash flow projections,
- Capital plans, and
- Memorandums discussing the purposes or reasons for purchasing particular securities.

In addition, a credit union's history of holding specific types of securities to maturity can be a form of documentation. A credit union's management shall recognize that GAAP envisions that sale and transfer out of the *held-to-maturity* category generally should be rare and that any such transactions may raise questions about the appropriateness of the credit union's designation of other securities as *held-to-maturity*.

Trading Securities

This account records the purchase, sale, and adjustments of trading securities to fair value.

Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as *trading securities* and reported at fair value through the income statement. Characteristic of trading is active and frequent buying and selling, and *trading* securities are generally used with the objective of generating profits on short-term differences in price. Unrealized holding gains and losses for *trading* securities are included in the income statement. Dividend and interest income,

including amortization of premium and discount, are included in the income statement.

Illustrative Entries

a) To record purchase of trading securities:

Dr.- Trading Securities	\$150,000	
Cr.- Cash		\$150,000

b) To record increase in fair value (opposite entry to record decrease in fair value):

Dr.- Trading Securities	\$5,000	
Cr.- Trading Profits and Losses		\$5,000

c) To record interest earned on trading securities:

Dr.- Cash	\$9,000	
Cr.- Interest on Trading Securities		\$9,000

d) To record the sale of the security at fair value:

Dr.- Cash	\$155,000	
Cr.- Trading Securities		\$155,000

Detailed Transactions

Debit:

- With the purchase of trading securities.
- With the periodic write-up of trading securities to fair value.

Credit:

- With the sale of trading securities.
- With the periodic write-down of trading securities to fair value.

Securities Available-For-Sale

This account is used to record available-for-sale securities (AFS). Securities not classified as *trading* and not meeting the requirements of *held-to-maturity* shall be classified as securities *available-for-sale*

(AFS). Debt and equity securities classified as AFS are reported at fair value through a separate component of equity (Other Comprehensive Income) in the balance sheet, Accumulated *Unrealized Gains/Losses on AFS*.

For credit union boards, in particular, fair value measurement gives them the information they need to oversee their credit unions. If securities in the AFS portfolio drop in fair value below book value, a credit union board will have a ready indicator of this decline in the balance sheet separate equity account. Fair value measurement is a tool credit union management, credit union boards, and regulatory staff need to ensure the safety and soundness of credit unions. Adjustments shall be made directly to the investment account. Unrealized holding gains and losses shall be excluded from the income statement and reported as a net amount in a separate component of equity (other comprehensive income) on the balance sheet until realized. Dividend and interest income, including amortization of premium and discount, shall continue to be included in the income statement.

Premiums and Discounts

Credit unions often purchase AFS investments at a premium or a discount. Credit unions should account for the premium and/or discount using the interest method and include the amortization of the premium and/or discount in the income statement. GAAP does permit straight-line or other alternative methods if the results do not vary materially from those obtained using the interest rate method.

The mechanics of accounting for the premiums or discounts on available-for-sale investments differs slightly from the accounting for the premiums or discounts on held-to-maturity investments. An accounting difference exists because credit unions must account for market fluctuations on available-for-sale investments in conjunction with the associated premium or discount. The following examples should provide additional information and relevant entries.

- The first set of entries details the method required under GAAP when purchasing AFS securities at a discount.

- Subsequently, for comparison purposes, the same entries are shown side by side for HTM and AFS securities.
- The third set of entries details the common practice in credit unions for the accounting of premiums and discounts on AFS securities. This method may be used if not resulting in material misstatement.

Illustrative Entries:

On 06/30/01, the credit union purchases a U.S. Treasury obligation \$100,000 par, at a discount of \$6,657.50. Assume the Treasury note has a nominal rate of 7 percent with a semiannual coupon payment. The annual yield to maturity is 8 percent, or 4 percent per coupon period.

On 12/31/2001, market conditions change and the fair value of the investment increases to \$102,000.

On 6/30/02, the market changes again and the fair value declines to \$92,000.

Using the interest method to accrete the discount, the accretion table below was developed. The following illustrates the appropriate entries and/or additional explanation:

a) At time of purchase, the credit union would make the following entry and develop an amortization table that is illustrated on below:

Dr.- AFS	\$93,342.50
Cr.- Cash	\$93,342.50

b) To record the unrealized gain and interest income received on 12/31/01.

Dr.- AFS	\$8,657.50
Dr.- Cash	3,500.00
Cr.- Investment Income	\$3,733.70
Cr.- Unrealized Gain on AFS	8,423.80

c) To record the unrealized loss and the interest income received on 6/30/02.

Dr.- Unrealized Loss on AFS	\$10,243.05
Dr.- Cash	3,500.00
Cr.- Investment Income	\$3,743.05
Cr.- AFS	10,000.00

Period	7% Coupon Interest (a)	8% Effective Interest (b)	Accretion Amount (c)	Carrying Amount (d)	Discount	Par Value
6/30/01				\$93,342.50	\$6,657.50	\$100,000
12/31/01	\$3,500	\$3,733.70	\$233.70	93,576.20	6,423.80	
6/30/02	3,500	3,743.05	243.05	93,819.25	6,180.75	
12/31/02	3,500	3,752.77	252.77	94,072.02	5,927.78	

(a) = 7% divided by 2 periods/year x \$100,000.

(b) = 8% divided by 2 periods/year x d.

(c) = (b) - (a).

(d) = Previous (d) balance + (c).

\$233.70 x 73/184 days (Table above)

Comparison Entries (continued):

To build on this example, the following table compares the accounting entries necessary to account for identical securities; however, classified differently: held-to-maturity (HTM) as compared to available-for-

sale (AFS). For more on HTM securities, see the section following this one. Notice the recognition of income (derived from the amortization of the discount) and the adjustment of AFS to fair value (AFS). The AFS entries (right column) used as a basis for comparison are identical to those above.

Held-to-Maturity (HTM)	Available For Sale (AFS)
1. Purchase of Security 6/30/01:	1. Purchase of Security 6/30/01:
HTM Securities \$100,000	AFS \$93,342.50
Discount on HTM Securities \$6,657.50	Cash \$93,342.50
Cash 93,342.50	
2. To record the interest income received on 12/31/01 and the accretion of the discount on the HTM security.	2. To record the interest income received on 12/31/01 while accreting the discount and the unrealized gain on the AFS security.
Cash \$3,500.00	Cash \$3,500.00
Discount on HTM 233.70	AFS 8,657.50
Investment Income 3,733.70	Investment Income \$3,733.70
	Unrealized Gain On AFS 8,423.80
3. To record the interest income received on 06/30/02 and the accretion of the discount on the HTM security.	3. To record the unrealized loss and the interest income received on 6/30/02 considering the accretion of the discount.
Cash \$3,500.00	Cash \$3,500.00
Discount on HTM \$243.05	Unrealized Loss On AFS 10,243.05
Investment Income \$3,743.05	Investment Income \$3,743.05
	AFS 10,000.00

AFS Note: In each instance, the credit union should balance back to the carrying value (i.e., column d) of the investment depicted in the above accretion table.

***Illustrative Entries Available For Sale (AFS)
(continued):
-- Common Credit Union Practice when AFS
Purchased at a Discount –Repeating Above Example***

Note: This approach is often seen in practice. It re-

sults in the proper GAAP valuation ultimately, but does not comply with GAAP in financial statement presentation. Examiners will urge you to move to the GAAP approach discussed previously because of the incorrect use of a contra asset account (see c)) in this developed practice approach.

a) Purchase of Security 6/30/01:

Dr.- AFS	\$100,000
Cr.- Discount on AFS	\$6,657.50
Cr.- Cash	93,342.50

b) To record the interest income received on 12/31/01 while accreting the discount on the AFS security.

Dr.- Cash	\$3,500.00
Dr.- Discount on AFS	233.70
Cr.- Investment Income	\$3,733.70

c) To adjust AFS to \$102,000 fair value:

Dr.-Contra Asset	
Mark to FV	
Account	\$8,423.80
Cr.- Accumulated	
Unrealized G/L on AFS	\$8,423.80

*--Net value of AFS:	
AFS	\$100,000.00
Discount on AFS	(6,423.80)
Contra Asset Mark to FV	
Account	8,423.80
	<u>\$102,000</u>

d) To record the interest income received on 06/30/02 and the accretion of the discount on the AFS security.

Dr.- Cash	\$3,500.00
Dr.- Discount on AFS	243.05
Cr.- Investment Income	\$3,743.05

e) To adjust AFS to \$92,000 fair value:

Dr.- Unrealized Gains/	
Losses on AFS	\$10,243.05
Cr.- Contra Asset Mark to	
FV Account	\$10,243.05

*--Net value of AFS:	
AFS	\$100,000.00
Discount on AFS	(6,180.75)
Contra Asset Mark to FV	(1,819.25)
Account	
	<u>\$92,000</u>

Mutual Funds are considered to be marketable equity securities. The fair value of a mutual fund investment

is readily determinable and published, and is the basis for current transactions. An investment in a mutual fund must be classified in either the *Available-for-Sale or Trading* categories. Adjustments shall be made directly to the investment account; no allowance for investment losses account or related provision shall be used.

Illustrative Entries (Assume Mutual Fund):

a) When the credit union invests in an AFS security:

Dr.- AFS	\$10,000
Cr.- Cash	\$10,000

b) When income on an AFS is reinvested and credited by the fund manager to the account of the investing credit union:

Dr.- AFS	\$500.00
Cr.- Income from AFS	\$500.00

c) When the credit union marks the investment to \$11,500 fair value:

Dr.- AFS	\$1,000.00
Cr.- Accumulated	
Unrealized G/L on AFS	\$1,000.00

d) When the credit union withdraws its investment in the mutual fund receiving \$10,300:

Dr.- Cash	\$10,300.00
Dr.- Accumulated	
Unrealized G/L	1,000.00
on AFS	
Dr.- Loss on	
Disposition of	
Investments	200.00
Cr.- AFS Securities	\$11,500.00

Note: Unrealized gains or losses on AFS are reversed upon disposition and the accumulated net amount realized through the income statement.

Detailed Transactions for AFS

Debit:

- a) With amounts of each security classified as available-for-sale.
- b) With amounts of write-ups to fair value.
- c) With income reinvested in the equity security by the fund manager, based on periodic advices of income received from the trust.

Credit:

- a) With amounts of write-downs to fair value.
- b) With amounts of withdrawals from equity securities.

Securities Held-To-Maturity

This account is used to record all securities for which the credit union has the intent and ability to hold to maturity. Types of securities properly recorded in this account include obligations of the United States of America or securities that are fully guaranteed as to both principal and interest thereby:

- a) Appreciation type, U.S. Government Obligations are generally purchased at a discount. Income is recorded periodically through accretion of discount (systematic reduction of discount by charge to income) and based on tables of redemption provided by the U.S. Treasury. By the manner in which income is earned, zero coupon bonds are a special class of “appreciation type” obligations.
- b) Current income type. The U.S. Government Obligation is purchased at face value (par value) and a uniform interest rate is paid semiannually by check during the life of the savings bond.
- c) General type of obligations. These U.S. Government Obligations are purchased on the open market or subscribed for at the time of the original issue. They may be registered with periodic interest checks being sent to the credit union, or interest may be received by cashing coupons that mature at stated intervals.
- d) Also included are so-called “agency” securities and participation certificates as permitted by the Federal Credit Union Act. The “agency” securities are bonds, notes and debentures issued by agencies

of the United States Government and secured by collateral owned by these agencies. They are not guaranteed by the United States. Information about “agency” securities can be obtained from banks as well as from dealers in securities. The Federal Reserve bulletin publishes a list of securities outstanding by each agency. “Agency” securities may be purchased on the open market. Information on participation certificates can be obtained by contacting the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association.

When a credit union acquires a security, it should assess its intent and ability to hold to these securities and assign its debt and equity securities to the appropriate measurement category: held-to-maturity available-for-sale, or trading. Not less frequently than the end of each dividend period (i.e., monthly, quarterly, semi-annually, or annually), the appropriateness of the classifications, and the reasonableness and accuracy of the related fair value measurement (trading and available-for-sale) shall be assessed.

Debt securities that the credit union has the positive intent and ability to hold to maturity shall be classified as securities held-to-maturity and reported at amortized cost, i.e., cost adjusted for the amortization of premiums or the accretion of discounts. To qualify as having established intent to hold to maturity, the credit union cannot have an intent to hold the security only for an indefinite period. The credit union has failed to meet the “hold-to-maturity” test if a security is sold due to the following:

- Changes in market interest rates and related changes in prepayment risk,
- Need for liquidity,
- Changes in funding sources and terms,
- Changes in the availability of and the yield on alternative security, etc.

A credit union’s alternatives are to classify the security as either *available-for-sale* or in a *trading account*.

Through an established and documented asset-liability management (ALM) strategy, a credit union may decide that it can accomplish its ALM strategic plans/goals without having all of its debt securities classified available-for-sale. Measurement standards acknowledge that even though a credit union considers the maturity and re-pricing characteristics of all of its debt securities as part of its asset-liability management, the credit union may determine that it can carry out the ongoing adjustments to its asset-liability position without having all of its debt securities *available-for-sale*. In such a situation, the credit union may earmark specific debt securities as unavailable to be sold for purposes of adjusting its asset-liability position. This would enable the earmarked securities to be placed in the *held-to-maturity* category provided the credit union otherwise has the positive intent and ability to hold them to maturity.

A credit union could experience any of the following “changes in circumstances” which may cause a credit union to sell or transfer a *held-to-maturity* security to another classification without raising questions about whether it was appropriate for that security to have been reported previously as *held-to-maturity*:

- a) A significant deterioration in the issuer’s creditworthiness.
- b) A merger, purchase and assumption, or other business combination that necessitates the sale or transfer of *held-to-maturity* securities to maintain the credit union’s existing interest-rate risk position or credit risk policy.
- c) A change in statutory or regulatory requirements causing the credit union to dispose of a held-to-maturity security (e.g., mandated change to risk based capital reserving structure).
- d) A significant increase by the regulator in capital requirements that causes the credit union to downsize by selling held-to-maturity securities.

Additionally, a credit union can successfully defend the sale of a *held-to-maturity* security, prior to maturity, under either of the two conditions:

- a) The sale is so near the maturity date (e.g., within three months) that the security’s value is little affected by changes in market interest rates.
- b) The sale occurs after the credit union has already collected a substantial portion (e.g., 85 percent or more) of the principal outstanding at acquisition.

Reverse repurchase and repurchase arrangements do not in and of themselves preclude a credit union from placing such securities in the *held-to-maturity* category, provided the credit union otherwise has the positive intent and ability to hold the securities to maturity. Furthermore, if, at the point of purchase of a CMO, a credit union can demonstrate that all probable future liquidity needs can be met through the sale of other securities, then the classification of the CMO as *held to maturity* will be accepted.

Detailed subsidiary records should be kept of held-to-maturity securities by type of security, including individual tracking of related cost, discounts and premiums, and fair value. Periodic reconciliation of the subsidiary records to this control account must be made.

Premiums and Discounts

Securities may be acquired at a premium, a price in excess of face value, or at a discount, a price less than face value. When a U.S. Government Obligation is purchased, the par value of the security should be recorded, as well as any discount or premium associated with this purchase. For presentation on the Statement of Financial Condition, discounts should be deducted from, and premiums should be added to the par value of the investment with the net amount being reflected in the balance of “Held-to-Maturity Securities”.

If the securities are purchased at a premium, the premium should be amortized over the period from date of acquisition to maturity. If the securities are purchased at a discount, the discount should be accreted under the theory that the securities normally can be expected to increase in market value over their remaining life.

There are two popular methods of amortizing premiums and accreting discounts: the straight-line method and the interest method. The straight-line

method results in equal periodic adjustments to earnings from the time of purchase to the maturity date. This method is simple to compute and affects earnings by the same amount each period.

Interest Method Of Amortization

The interest method recognizes an amount in earnings each period that produces a constant yield equal to the market yield at the date of purchase. Under this method, the amount of discount accreted or premium amortized increases or decreases, respectively, each period so that over the course of holding the investment, a level yield on the investment is maintained.

The interest method of accreting discount or amortizing premium should be used unless the results obtained when using the straight-line method or other methods of amortization or accretion do not vary materially from those that would be obtained by the interest method.

GAAP requires management to consider several factors when amortizing a premium or accreting a discount. If a credit union maintains investments for which prepayments are probable and the timing and the amount of prepayments can be reasonably estimated (e.g., Bloomberg), credit union management should consider estimates of future principal prepayments in the interest method calculation. If the credit union anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, management should recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment should be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the investment.

Generally accepted accounting principles (GAAP) recommend that the amortization of premium and accretion of discount be recorded in a manner that produces a constant rate of return on the basis of adjusted book value. This constant rate of return is achieved through the interest method. GAAP permits straight line or other alternative methods if the results obtained do not vary materially from those obtained using the interest method. However, management should periodically compare their alternative method

to the interest method in order to ensure that no material differences exist.

The interest method is applicable to several areas under GAAP. The investment area is one of the areas that benefits through application of the interest method. The interest method would be applicable for securities that are purchased at a premium (a price greater than par) or discount (a price less than the face value).

Credit union management could understate and/or overstate its investment portfolio by not properly applying the interest method. Therefore, credit union management should review the information pertaining to this methodology outlined in this *Manual* or by a thorough review of GAAP literature. If application of the methodology remains unclear, the credit union should seek the guidance of an independent accountant.

Posting to the General Ledger

Entries to this account are posted individually from the "Miscellaneous" columns of the Journal and Cash Record.

Identification of Securities

Securities purchased and disposed of should be clearly identified in the "Explanatory Remarks" column of the General Ledger account. It is desirable to have a record of the name of the issue, the interest rate, the maturity and the serial numbers of the securities owned, and sold, so that this account will show the actual holdings of the credit union, and thus make verification easier. If there are several investments, subsidiary ledgers should be used.

Illustrative Entries:

Purchase of a U.S. Treasury obligation between interest dates, \$100,000 par, at a discount of \$6,657.50, paying \$95,453.91 which includes accrued interest of \$2,111.41.

(Note: The credit union is charged the cost of the obligation plus accrued interest income from the last interest date, 6/30/01, to the purchase date, 10/19/01.)

Assume the Treasury note has a nominal rate of 7 percent with a semiannual coupon payment. The annual yield to maturity is 8 percent, or 4 percent per coupon period.

Using the interest method to accrete the discount, the accretion table below was developed. The following illustrates the appropriate entries and/or additional explanation:

Period	7% Coupon Interest (a)	8% Effective Interest (b)	Accretion Amount (c)	Carrying Amount (d)	Discount	Par Value
10/19/01				\$93,342.50	\$6,657.50	\$100,000
12/31/01	\$3,500	\$3,733.70	\$233.70	93,576.20	6,423.80	
6/30/02	3,500	3,743.05	243.05	93,819.25	6,180.75	
12/31/02	3,500	3,752.77	252.77	94,072.02	5,927.78	

(a) = 7% divided by 2 periods/year x \$100,000.

(b) = 8% divided by 2 periods/year x d.

(c) = (b) - (a).

(d) = Previous (d) balance + (c).

a) Purchase of a U.S. Treasury obligation between interest dates:

Dr.- HTM Securities	\$100,000.00
Dr.- Purchased Accrued Interest Receivable on HTM securities	2,111.41
Cr.- Cash	\$95,453.91
Cr.- Discount on HTM Securities	6,657.50

b) To record the receipt of interest on 12/31/01 and the accretion of the discount, 10/20/01 through 12/31/01:

Dr.- Cash	\$3,500.00
Dr.- Discount on HTM Securities	92.72*
Cr.- Income from U.S. Government Obligations	\$1,481.31
Cr.- Purchased Accrued Interest receivable on HTM securities	2,111.41

* \$233.70 x 73/184 days=\$92.72

c) To accrue income and accrete the discount for the period, 1/1/02 through 3/31/02:

Dr.- Discount on HTM Securities	\$ 121.52
Dr.- Accrued Income from Investments	1,750.00
Cr.- Income from U.S. Government Obligations	\$1,871.52

d) To record the receipt of interest on 6/30/02 and the accretion of the discount, 4/1/02 through 6/30/02:

Dr.- Cash	\$3,500.00
Dr.- Discount on HTM Securities	121.52
Cr.- Income from U.S. Government Obligations	\$1,871.52
Cr.- Accrued Income from Investments	1,750.00

e) To record the sale of the U.S. Treasury Obligations on 9/30/02 @ \$94,500.00. (Note: Generally, an obligation of this type would be held longer than 11 1/2 months; this example is for illustrative purposes only.)

First, record the interest receivable from 7/1 to 9/30/02 and the associated accretion of the discount:

Dr.- Accrued Income	
from Investments	\$1,750.00
Dr.- Discount on HTM	
Securities	126.38
Cr.- Income from U.S.	
Government	\$1,876.38
Obligations	

Next, record the sale entry:

Dr.- Cash	\$96,250.00
Dr.- Discount on HTM	
Securities	6,054.37
Cr.- HTM Securities	\$100,000.00
Cr.- Accrued Income on	
Investments	1,750.00
Cr.- Gains on Investments	554.37

Note: The cash received equals the sales price (\$94,500) plus accrued interest receivable (\$1,750). Look to next table for the following entries:

f) Purchase of a U.S. Treasury obligation between interest dates, \$100,000 par, at a premium of \$5,444.18, paying \$107,860.22 which includes accrued interest of \$2,416.04.

(Note: The credit union is charged for the cost of the obligation plus accrued interest income from the last interest date, 6/30/01, to the purchase date, 10/19/01.)

Assume the Treasury note has a nominal rate of 8 percent with a semiannual coupon payment. The annual yield to maturity is 7 percent, or 3.5 percent per coupon period.

Using the interest method to amortize the premium, the amortization table and entry would be as follows:

Period	8% Coupon Interest (a)	7% Effective Interest (b)	Amortization Amount (c)	Carrying Amount (d)	Premium	Par Value
10/19/01				\$105,444.18	\$5,444.18	\$100,000
12/31/01	\$4,000	\$3,690.55	\$309.45	105,134.73	5,134.73	
6/30/02	4,000	3,679.71	320.28	104,814.45	4,814.45	
12/31/02	4,000	3668.50	331.49	104,482.96	4,482.96	

(a) = 8% divided by 2 periods/year x \$100,000.

(b) = 7% divided by 2 periods/year x (d).

(c) = (a) - (b).

(d) = Previous, balance (d) - (c).

* - \$309.45 (Table, Column (c) - 73/184 days)

Dr.- HTM Security	\$100,000.00
Dr.- Accrued Income from Investments	2,416.04
Dr.- Premium on HTM Securities	5,444.18
Cr.- Cash	\$107,860.22

g) To record the receipt of interest on 12/31/01 and the amortization of the premium, 10/20/01 through 12/31/01:

Dr.- Cash	\$4,000.00
Cr.- Income from U.S. Government Obligations	\$1,461.19
Cr.- Premium on HTM Securities	122.77
Cr.- Accrued Income from Investments	2,416.04

h) To accrue income and amortize the premium for the period, 1/1/02 through 3/31/02:

Dr.- Accrued Income on Investments	\$2,000.00
Cr.- Income from U.S. Government Obligations	\$1,839.86
Cr.- Premium on HTM Securities	160.14

i) To record the receipt of interest on 6/30/02 and the amortization of the premium, 4/1/02 through 6/30/02:

Dr.- Cash	\$4,000.00
Cr.- Income from U.S. Government Obligations	\$1,839.86
Cr.- Premium on HTM Securities	160.14
Cr.- Accrued Income from Investments	2,000.00

Journal entries similar to bullet (g) and bullet (i) should be made on a continuing basis each dividend

period until the U.S. Government Obligations are sold or redeemed.

Illustrative Entries (continued):

Purchase of a collateralized mortgage obligation (CMO) for \$10,000,000 par, at a discount of \$200,000. The investment specifies equal annual payments with no penalty for prepayments. The credit union decides to account for this investment using the anticipated prepayment patterns to apply the interest method of amortization. The credit union estimates a constant prepayment rate of 6 percent per year based on the current and foreseeable economic conditions. In years 1 and 2, the investment actually prepays at a rate of 6 percent. Based on new information (e.g., market conditions), the credit union revises its estimate of prepayment experience to anticipate that 10 percent of the investment will repay in year 4 and that 6 percent of the investment will repay in the remaining years.***

The credit union would record the initial investment as stated in prior sections. When management calculates the effective yield in year 3 and adjusts the carrying value as if the new yield had been applied since acquisition, the cumulative effect of this adjustment is recognized in current period income. The following represents the adjusting entry of \$8,876 to be recorded as the credit union revises its original estimation of prepayments. If the credit union had not reevaluated the prepayment assumptions, management would have been forced to make a substantial adjusting entry at the conclusion of this investment. Please note that an adjustment would have been also required if the level of prepayments realized was less than anticipated.

Dr.- Discount on Investments	\$8,876	
Cr.- Investment Income		\$8,876

***-Example borrowed, in part, with permission from the Financial Accounting Standards Board, Statement No. 91.

Year	Cash (Out) Inflow	Stated Interest (10%)	Amortization	Interest Income	Remaining Principal	Unamortized Discount	Carrying Amount
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	(\$9,800,000)				\$10,000,000		
1	2,227,454	\$1,000,000	\$35,141	\$1,035,141	8,772,546	\$164,859	\$8,607,687
2	2,049,623	877,255	31,946	909,201	7,600,178	132,913	7,467,265
3	2,944,644	760,018	41,951	801,969	5,415,552	90,962	5,324,590
4	1,653,939	541,555	23,294	564,849	4,303,168	67,668	4,235,500
5	1,246,229	430,317	18,998	449,315	3,487,256	48,670	3,438,586
6	1,129,164	348,726	16,050	364,776	2,706,818	32,620	2,674,198
7	1,016,331	270,682	13,050	283,687	1,961,169	19,615	1,941,554
8	906,285	196,117	9,849	205,966	1,251,001	9,766	1,241,235
9	795,875	125,100	6,574	131,674	580,226	3,192	577,034
10	638,249	58,023	3,192	61,215	0	0	0
	Total Amortization		\$200,000				

*** Note: The above table appeared in FAS 91 and was reprinted with the permission of the FASB.

Computations:

Column (1) – Contractual payments + prepayments

Column (2) – Column (5) for prior year x the loan's stated interest rate (10%)

Column (3) – Column (4) - Column (2)

Column (4) – Column (7) for the prior year x the effective interest rate (10.5627% for years 1 and 2, and 10.6083% for years 3-10, + an adjustment of \$8,876 in year 3 representing the cumulative effects applicable to year 1 to 2 of changing the estimated effective rate.

Column (5) – Column (5) for prior year - (Column (1) - Column (2))

Column (7) – Column (5) - Column (6)

OTHER SECURITY CONSIDERATIONS

Transfers Between Categories

Transfers between categories shall be accounted for at fair value with unrealized holding gains or losses accounted for as shown in the table which follows. Transfers into and out of the *held-to-maturity* category should be rare. Furthermore, a decision to designate a security as *held-to-maturity* may affect a credit union's ability to freely transfer or sell the security. Transfers out of the *held-to-maturity*

category by definition jeopardize a credit union's ongoing ability to carry any securities as *held-to-maturity* at amortized cost. As a result, a credit union's initial designation of its securities may adversely affect the degree of flexibility it has to manage its securities portfolio as a secondary source of liquidity.

Given the nature of a *trading* account, transfers into or out of the *trading* category should also be rare.

Investment Transferred From/To:	Transfer at:	Unrealized Holding Gain or Loss
From <i>Trading</i> category	Fair Value	Already recognized in earnings and shall not be reversed
To <i>Trading</i> category	Fair Value	Recognized in earnings immediately
To <i>Available-for-sale</i> category from Held-to-maturity category	Fair Value	Separate component of shareholder's equity
To <i>Held-to-maturity</i> category from the <i>Available-for-sale</i> category	Fair Value	Continue reporting as a separate component of shareholders' equity but begin amortization over the remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount.

Impairment of Securities

If the credit union experiences a decline in either an *available-for-sale* or *held-to-maturity* security's value which is *other-than-temporary*, the cost basis of the individual security shall be written down to fair value as a new cost basis and the write-down included in the income statement as a realized loss. An other-than-temporary impairment should be considered to have occurred if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition. The new cost basis shall not be changed for subsequent recoveries in fair value.

Definitions

Certain investment transactions and activities defined below may or may not be permissible for federal credit unions in accordance with Sections 107(7) and 107(8) of the Federal Credit Union and Part 703 of the National Credit Union Administration Rules and Regulations. Additional definitions are also available in the referenced part of the Rules and Regulations.

Adjusted Trading - Any method or transaction used to defer a loss whereby a federal credit union sells a security to a vendor at a price above its current market price and simultaneously purchases or

commits to purchase from that vendor another security above its current market price.

These investments are highly complex. In order to understand the transactions and activities the reader must understand the following terminology.

Cash Forward Agreement - An agreement to purchase or sell a security, at a future date, with delivery and acceptance being mandatory. The contract for the purchase or sale of a security for which delivery of the security is made in excess of thirty (30) days but not exceeding one hundred-twenty (120) days from the trade date shall be considered to be a cash forward agreement.

Debt security - Any security representing a creditor relationship with an entity. As it applies to federal credit unions, debt securities include such investments as U.S. Treasury securities and Mortgage Backed Securities (MBSs) such as mortgage pass-through securities and Collateralized Mortgage Obligations (CMOs). Debt securities do not include accounts receivable on member loans.

Equity security - Any security representing an ownership interest in an entity or the right to acquire or dispose of such ownership at fixed or determinable prices. An example of an equity security investment is a mutual fund.

Fair value - The current amount at which an investment could be bought, sold, or otherwise exchanged between willing parties, other than in a forced liquidation sale.

Futures Contract - A standardized contract for the future delivery of commodities, including certain government securities, sold on designated commodities exchanges.

Holding gain or loss - The net change in fair value of a security. It does not include earned dividends or interest which have not been received or write-downs resulting from permanent declines in fair value.

Market Price - The last established price at which a security is sold.

Maturity Date - The date on which a security matures. It does not mean the call date or the average life of the security.

Repurchase Transaction - A transaction in which a federal credit union agrees to purchase a security from a vendor and to resell the same or any identical security to the vendor at a later date. See NCUA Rules & Regulations §703.100(i).

Reverse Repurchase Transaction - A transaction whereby a federal credit union agrees to sell a security to a purchaser and to repurchase the same or any identical security from the purchaser at a future date and at a specified price. A reverse repurchase transaction represents a borrowing transaction and is subject to the limitations of Section 107(9) of the Act.

Safekeeping Agreement-A contract whereby a third party of other financial institution, for a fee, agrees to exercise ordinary care in protecting the securities held in safekeeping for its customers.

Settlement Date - The date originally agreed to by a federal credit union and a vendor for settlement of the purchase or sale of a security.

Security - Share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that (a) either is represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered

in books maintained to record transfers by or on behalf of the issuer, (b) is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment, and (c) either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Short Sale - The sale of a security not owned by the seller.

Standby Commitment - An agreement to sell a security on or before a future date at a predetermined price. The seller of the agreement is required to accept delivery of the security (in the case of a commitment to buy) or make delivery of a security (in the case of a commitment to sell) in either case at the option of the buyer of the commitment.

Trade Date - The date the federal credit union originally agreed, whether verbally or in writing, to enter the purchase or sale of a security with a vendor.

Investment types and terms are further defined in Part 703, NCUA Rules and Regulations.

Examples of Transactions Involving Securities

Reverse Repurchase Transaction

A federal credit union may enter into a reverse repurchase transaction, provided no securities purchased with the funds received from the reverse repo, nor any securities collateralizing the reverse repo, have a maturity date later than the settlement date for the reverse repo.

The maximum amount of funds that may be borrowed under a reverse repurchase transaction for investment or deposit purposes is 50 percent of the credit union's paid-in and unimpaired capital.

Since reverse repos represent a borrowing activity, such activity must be approved by the board of directors or a duly appointed executive committee as required by Section 113 of the Federal Credit Union Act. The funds received from the reverse repos should be recorded as borrowed funds in "Notes Payable-Other,". Interest paid on reverse repos

should be recorded in "Interest on Borrowed Money,".

Illustrative Entries

In this example, the securities loaned have a carrying amount and fair value of \$1,000. The Cash "collateral" is in the amount of \$1,020. The transferor's return from investing the cash collateral at a 5 percent annual rate was \$5.00. The transferor's rebate to the borrower at a 4 percent annual rate was \$4.00. In addition, assume the loaned securities cannot be redeemed on short notice, for example, by substitution of other collateral. For simplicity, the fair value of the security is assumed not to change during the 35-day term.

Journal Entries for the Transferor.

At inception:

- (1) To record the receipt of cash collateral

Dr.- Cash	\$1,020	
Cr.- Payable under securities loan agreements		\$1,020

- (2) To reclassify loaned securities that cannot be redeemed on short notice.

Dr.- Securities loan to broker	\$1,000	
Cr.- AFS		\$1,000

- (3) To record investment of cash collateral.

Dr.- Money Market instrument	\$1,020	
Cr.- Cash		\$1,020

At conclusion:

- (1) To record results of investments.

Dr.- Cash	\$1,025	
Cr.- Interest		5
Cr.- Money market instrument		\$1,020

- (2) To record return of security.

Dr.- AFS	\$1,000	
Cr.- Securities loaned to broker		\$1,000

- (3) To record repayment of cash collateral plus interest.

Dr.- Payable under securities loan agreements	\$1,020	
Dr.- Interest ("rebate")	4	
Cr.- Cash		\$1,024

Journal Entries for the Transferee.

At inception:

- (1) To record transfer of cash collateral.

Dr.- Receivable under securities loan agreements	\$1,020	
Cr.- Cash		\$1,020

- (2) To record receipt of borrowed securities that cannot be redeemed on short notice.

Dr.- AFS	\$1,000	
Cr.- Obligation to return borrowed securities		\$1,000

At conclusion:

- (1) To record the return of the securities.

Dr.- Obligation to return borrowed securities	\$1,000	
Cr.- AFS		\$1,000

- (2) To record the receipt of cash collateral and rebate interest.

Dr.- Cash	\$1,024	
Cr.- Receivable under securities loan agreements		\$1,020
Cr.- Interest revenue ("rebate")		4

Securities Lending Transaction

A securities lending transaction is similar to the reverse repurchase transaction described above except that the cash does not go to the transferor. Instead of receiving the cash, a third party (broker/dealer) invests the funds for the credit union. As a result, a fee income is derived (net of charges from broker/dealer).

OTHER INVESTMENT ACTIVITIES

Part 703, NCUA Rules and Regulations, identifies investments that federal credit unions may invest in. Section 107(7) and 107(8) of the Federal Credit Union Act authorize these securities. Federal credit unions should refer to these sources prior to making investment decisions.

Not all the permissible investments for credit unions are covered in the following sections. A few examples of permissible investments and the recommended accounting treatment are shown.

Deposits in Commercial Banks, S&Ls, Savings Banks

These accounts are used to record investments in shares, deposits and certificates of financial institutions other than credit unions. Sections 107(7) and 107(8) of the Federal Credit Union Act authorize such investments including:

a) Shares or accounts of savings and loan associations or mutual savings banks insured by the Federal Deposit Insurance Corporation (FDIC);

b) Deposits in national banks and in state banks, trust companies, and mutual savings banks operating in accordance with the laws of the state in which the federal credit union does business, or in banks or institutions the accounts of which are insured by the FDIC.

Subsidiaries of the General Ledger Accounts

If the credit union has two or more investments in other shares, deposits or certificates, it is recommended that subsidiary records be maintained to clearly identify each investment transaction. If subsidiary records are maintained, it should not be

necessary to complete the "Explanatory Remarks" column of the General Ledger account.

Illustrative Entries

a) When investments are made in shares or deposits, other than with another credit union:

Dr.- Commercial Bank Deposits		\$50,000
	OR	
Dr.- Savings & Loan and Mutual Savings Bank Deposits		\$50,000
Cr.- Cash		\$50,000

b) When investments are withdrawn or redeemed:

Dr.- Cash		\$1,000
Cr.- Other Shares, Deposits and Certificates		\$1,000

c) When income earned on such deposits are automatically reinvested:

Dr.- Commercial Bank Deposits		\$1,000
	OR	
Dr.- Savings & Loan and Mutual Savings Bank Deposits		\$1,000
Cr.- Income from Other Shares, Deposits and Certificates		\$1,000

d) To record the withdrawal of shares, deposits or certificates:

Dr.- Cash		\$25,000
Cr.- Commercial Bank Deposits		\$25,000
	OR	
Cr.- Savings & Loan and Mutual Savings Bank Deposits		\$25,000

Detailed Transactions

Debit:

a) With deposits and investments in commercial banks, savings & loan associations and mutual savings banks.

b) With income earned on deposits and investments and reinvested in commercial banks, savings & loan associations, or mutual savings banks. (Note: This entry assumes that the income is added to the deposit or investment rather than received by separate check.)

Credit:

a) With withdrawals or redemptions of deposits and investments in commercial banks, savings & loan associations, and mutual savings banks.

Deposits in Corporate Credit Unions

Membership Capital at Corporate Credit Unions

Represents funds invested in a corporate credit union that have a minimum withdrawal notice of three years, are not insured by the NCUSIF or other share or deposit insurers, and cannot be used to pledge against borrowings. These funds are available to a corporate credit union to cover losses that exceed reserves, undivided earnings and paid-in-capital. A credit union may sell its membership capital to another credit union in the corporate credit union's field of membership, subject to the corporate credit union's approval. The funds may be in the form of a term certificate, or may be in the form of an adjusted balance account. An adjusted balance account may be adjusted in relation to a measure (e.g. one percent of a member credit union's assets) established and disclosed by the corporate credit union at the time the account is opened without regard to any minimum withdrawal notice period.

Therefore, these funds are accounted for like other certificates or other adjusted longer-term accounts.

Paid-In Capital at Corporate Credit Unions

Represents funds invested in a corporate credit union with an initial maturity of a least 20 years. This account is not insured by the NCUSIF or other share or deposit insurers.

All Other Investments in Corporate Credit Unions

Represents all other investments at a corporate credit union that did not fall into the category of cash and cash equivalents, membership capital or paid-in capital. The accounting for these instruments will be similar to the accounting shown for investments in banks and S&L's.

PERMISSIBLE INVESTMENT ACTIVITIES AND TRANSACTIONS SUBJECT TO SPECIFIED CONDITIONS

Pair-Off Transaction

A pair-off is a security purchase transaction that is closed or sold at, or prior to, the settlement date.

Generally, a federal credit union could commit to purchase a security and sometime thereafter commit to sell the security on the same settlement date. The purpose in engaging in pair-off transactions is not to take delivery of the security purchased, but to speculate that the market price will increase before settlement date and a gain will result from its sale.

Many times the commitment to sell is made the same day as the commitment to purchase. There may even be a standing order with the vendor to sell when a certain market price is reached. Pair-off transactions represent a speculative activity which are generally unsafe and unsound. There is strong evidence to show that it has been used as a means of "churning" credit union accounts to generate brokerage commissions. Regardless, any pair off transactions must be accounted for as a "Trading Account".

Mortgage Pass-Through Securities

Mortgage pass-through securities were the first form of mortgage-collateralized securities to be issued. With a pass-through security, investors purchase an undivided interest in an underlying pool of mortgages that serves to collateralize the pass-through security. As the mortgages in the pool are repaid, principal and interest are passed through to each investor on a pro rata basis. All pass-through securities have an issue date; a coupon or pass-through rate; and a final or stated maturity date.

Mortgage originators, such as commercial banks, and S&Ls, etc., are among the most active in pooling mortgages and issuing pass-through securities. The originator usually issues a pass-through with the guarantee of a federally sponsored agency. In addition, a large volume of mortgages are purchased, pooled and collateralized under agency programs. The agencies that guarantee and issue pass-through securities are the Government National Mortgage Association (Ginnie Mae); the Federal Home Loan Mortgage Corporation (Freddie Mac); and the Federal National Mortgage Association (Fannie Mae).

When a pass-through is not backed by the guarantee of a federally sponsored agency, it falls into the category of "privately issued" and may be backed by pool insurance, letters of credit, and other credit enhancements.

Federal credit unions may invest in pass-through securities issued or guaranteed by the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), or the Federal Home Loan Mortgage Corporation (Freddie Mac). Under Section 107(15)(B) of the Federal Credit Union Act, federal credit unions may also invest in privately issued pass-through securities as defined in Section 3(a)(41) of the Securities Exchange Act of 1934.

When a credit union acquires a mortgage pass-through security, it must assess its intent and ability with regard to the security and assign it to the appropriate measurement category: *trading*, *held-to-maturity*, or *available-for-sale*. Not less frequently than the end of each dividend period, (i.e., monthly, quarterly, semiannually or annually), the appropriateness of the classifications, and the reasonableness and accuracy of the related measurement (*trading* and *available-for-sale*), shall be assessed.

Illustrative Entries

The IMU FCU purchased \$100,000 worth of pass-through securities for \$99,000. The securities have a 30-year life and have a 10% pass-through paid monthly. The annual effective yield to maturity is 10.12%. The credit union has the ability to hold the

investment to maturity and the positive intent to hold it for the foreseeable future.

(Note: This illustration assumes no significant changes in prepayment assumption from the purchase date to maturity, therefore, periodic adjustments to the investment carrying value are not illustrated.)

a) IMU's entry at the point of purchase.

Dr.- Held-to-Maturity Securities	\$100,000
Cr.- Discount on Held-to-Maturity Securities	\$1,000
Cr.- Cash	99,000

b) To record the receipt of the first monthly payment: the recognition of income at the effective rate, the accretion of discount (the difference between income at the pass-through rate and income at the effective rate), and the return of principal.

Dr.- Cash	\$877.75
Dr.- Discount on Held-to-Maturity Securities	1.57
Cr.- Income on Federal Agency Securities	\$834.90
Cr.- Held-to-Maturity Securities	44.42

c) To record the receipt of the second monthly payment: the recognition of income at the effective rate, the accretion of discount (the difference between income at the pass-through rate and income at the effective rate), and the return of principal.

Dr.- Cash	\$877.57
Dr.- Discount on Held-to-Maturity Securities	1.56
Cr.- Income on Federal Agency Securities	\$834.52
Cr.- Held-to-Maturity Securities	44.61

If the credit union holds this investment to maturity, they should receive a full return of principal plus interest.

If there is a significant change in prepayment assumptions on the underlying pool of mortgages, i.e., the underlying mortgages are paying significantly faster or slower than anticipated, the carrying value must be adjusted to reflect the change in prepayment rate.

This adjustment is accomplished by discounting the cash flows received to date, plus the cash flows the credit union anticipates to receive in the future based on the new prepayment assumptions back to the original purchase date to determine the new anticipated yield. The new yield thus calculated is then applied from date of purchase to calculate what the carrying value of the security would be today had the new yield been applied since purchase.

The booked carrying value is then adjusted through current period income to reflect the adjusted carrying value and the amortization is continued at the new effective rate.

Collateralized Mortgage Obligations (CMOs)

A CMO is a multi-class bond issue collateralized by whole mortgage loans or mortgage pass-through securities. The cash flows of the underlying mortgages are used to make the principal and interest payments on the bonds.

The key difference between a conventional mortgage pass-through security, such as a Government National Mortgage Association (Ginnie Mae) pass-through, and a CMO is in the distribution of principal payments. With a conventional pass-through, the interest and principal payments received each month from mortgage holders are passed through to all security holders on a pro rata basis. Because of prepayments, the pass-throughs cash flows tend to be irregular and widely dispersed over time. The security remains outstanding for as long as any of the mortgages in the underlying mortgage pool are outstanding (up to 30 years where the pass-through is backed by long-term mortgages).

The CMO structure substitutes sequential retirement of bonds for the pro rata return of principal found in the pass-through, the result of which is to create mortgage-backed securities with short, intermediate and long-term maturities.

Typically, the first class of CMO bonds receives all principal generated by the issue until it is completely retired; then the second class begins to receive principal until it is retired and so on. Interest is paid on all outstanding bonds unless they are accrual or "Z" bonds.

CMO's have been issued by the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) and have also been privately issued by securities firms, S&L's, mortgage bankers, home-builders, and life insurance companies. A federal credit union may invest in CMO's issued by Freddie Mac or Fannie Mae and privately-issued CMO's as defined by Section 3(a)(41) of the Securities Exchange Act of 1934.

Illustrative Entries

Suppose a credit union invested \$92,128.55 in the second tranche of a CMO valued at \$100,000. The credit union has the intent and ability to hold the investment to maturity. The estimated life of the second tranche of the CMO is 6 years with receipt of interest only for 3 years while the first tranche receives principal and interest payments and receipt of principal and interest payments for the next three years. The pass-through rate of interest is stated as 7% and the annual effective yield to maturity is expected to be 9.1936%.

(Note: This illustration assumes no significant changes in prepayment assumption from the purchase date to maturity, therefore, periodic adjustments to the investment carrying value are not illustrated.)

- a) The credit union's entry at the point of purchase.

Dr.-Held-to-Maturity Securities	\$100,000
Cr.- Discount on Held-to-Maturity Securities	\$7,871.45
Cr.- Cash	92,128.55

- b) To record the receipt of the first monthly payment: the recognition of income at the effective rate, the accretion of discount (the difference

between income at the pass-through rate and income at the effective rate) and the receipt of income at the pass-through rate while the first tranche is receiving a payment of principal plus interest.

Dr.- Cash	\$583.33
Dr.- Discount on Held-to-Maturity Securities	122.50
Cr.- Income on Federal Agency Securities	\$705.83

c) To record the receipt of the second monthly payment: the recognition of income at the effective rate, the accretion of discount (the difference between income at the pass-through rate and income at the effective rate) and the receipt of income at the pass-through rate while the first tranche is receiving a payment of principal plus interest.

Dr.- Cash	\$583.33
Dr.- Discount on Held-to-Maturity Securities	123.43
Cr.- Income on Federal Agency Securities	\$706.76

At the end of three years when the first tranche is fully satisfied, the second tranche will become a pass-through security and the accretion of discount using the interest method will proceed as demonstrated in the previous section to pass-through securities. Remember, when there is a significant change in prepayment assumptions (rates) the carrying value of the security must be adjusted through current period income.

Investment in the Central Liquidity Facility (CLF)

See the specialized section for specifics on this investment.

Zero Coupon Securities

A zero coupon security is a security that makes no periodic interest payments, but instead is sold at a deep discount to its face (par) value. The buyer of such a security realizes the rate of return by the gradual appreciation of the security, receiving the face value of the security as a lump sum payment on a specified maturity date.

Because zero coupon securities bear no interest, they are among the most volatile of all fixed income securities. Since holders of zero coupon securities do not receive interest payments, these securities fall more dramatically than bonds paying interest on a current basis when interest rates rise.

On the other hand, when interest rates fall, zero coupon securities rise more rapidly in value because the bonds have locked in a particular rate of reinvestment that becomes more and more attractive as rates fall further. The greater the number of years a zero coupon bond has until maturity, the less the investor has to pay for it and the more leverage the investor has at work for him.

For instance, a bond that matures in 5 years may double in value while a bond that matures in 25 years may increase in value 10 times, depending on the interest rate of the bond.

To be a permissible investment, the zero coupon security must have a maturity date that is 10 years or less from the settlement date.

Illustrative Entries

Assume a credit union purchased a \$1,500,000 zero coupon bond for \$534,000 expecting an effective yield of 10.6% to maturity in 10 years. Assume also that the credit union has the intent and ability to hold the zero to maturity.

a) The credit union's entry at the point of purchase.

Dr.-Held-to-Maturity Securities	\$1,500,000
Cr.- Discount on Held-to-Maturity Securities	\$966,000
Cr.- Cash	534,000

b) To record the receipt of the first semiannual accretion of discount:

Dr.-Discount on Held-to-Maturity Securities	\$28,302
Cr.- Income on U.S. Gov't Obligations	\$28,302

c) To record the receipt of the second semiannual accretion of discount:

Dr.-Discount on Held-to-Maturity Securities	\$29,802	
Cr.- Income on U.S. Gov't Obligations		\$29,802

Notice that after the first year, the carrying value of the zero coupon bond has grown from \$534,000 to \$592,104.

Accounting for Mutual Funds

When a credit union invests in a mutual fund, it purchases a number of shares (units) in the fund generally paying a broker's commission or load fee as part of the purchase price. The fund invests the proceeds from the sale of shares in a portfolio of securities to be held and /or traded for profit.

The broker's fee or commission is passed on to the broker securing the sale. Each mutual fund investors' share/unit in the mutual fund is worth an amount calculated based on the total market value of the number of outstanding units in the fund. This value per share is known as the net asset value per share. (NAV).

The NAV of a share/unit in the fund fluctuates periodically based on the changing market value of the underlying ties in the mutual fund portfolio, as well as the natural change in the value of the portfolio, inherent in continually buying and selling securities.

Generally, as interest rates fall, the value of the underlying securities in the mutual fund portfolio rises and, likewise, the NAV per share increases; conversely as interest rates rise, the value of the underlying securities in the mutual fund portfolio decreases and, likewise, the NAV per share drops. Thus, the credit union investor's NAV per share drops. The credit union's NAV per share is dynamic, rising and falling with interest rates and the changing securities market.

Generally accepted accounting principles (GAAP) provide that certain equity securities (like mutual funds) should be accounted for as trading or available-for-sale at fair value. Fair value for trading

accounts is booked through income; fair value for available-for-sale securities is debited/credited through a separate component of equity (other comprehensive income) in the statement of financial condition.

Illustrative Entries:

Assume a credit union purchased shares/units in three different mutual funds as follows:

1/13/01 Fund A - 10,000 shares @ \$10.00 per share
2/05/01 Fund B - 10,000 shares @ \$8.00 per share
3/20/01 Fund C - 4,000 shares @ \$16.00 per share

The accounting entries made on the credit union's books at the time of purchase are detailed below. The broker's commission (loan fee) is included in the quoted share/unit purchase price.

Dr.-Available-for-Sale Securities	\$245,000	
Cr.- Cash		\$245,000

To continue the example, at the quarter ending 3/31/01 when the credit union is closing its books but prior to paying dividends to its members, the credit union needs to adjust the mutual fund investments to the fair value. Assume that the 3/31/01 market values of the three funds are as shown in the table below:

Mutual Fund	Original Cost	Current Fair Value	Gain or (Loss)
A	\$100,000	\$ 95,000	(\$5,000)
B	80,000	80,000	
C	65,000	62,000	(3,000)
	<u>\$245,000</u>	<u>\$237,000</u>	<u>(\$8,000)</u>
	(A)	(B)	(B-A)

Although, the funds were purchased during the quarter for a total of \$245,000, the fair value of the funds in aggregate at 3/31/01 has declined to \$237,000. Therefore, the credit union should adjust

the carrying value of its mutual fund investments downward to the current fair value.

Dr.- Accumulated Unrealized Gains/Losses on Available-for-Sale Securities	\$8,000
Cr.- Available-for-Sale Securities	\$8,000

(Accumulated Unrealized Gains/Losses on Available-for-Sale Securities is part of Other Comprehensive Income and must be netted with Undivided Earnings before the credit union declares dividends.)

Assume during the second quarter, the mutual funds in aggregate increase in value. Assume that at the end of the second quarter, 6/30/01, when the credit union closes their books and before paying dividends, the mutual funds are valued as follows:

Mutual Fund	Current Balance Sheet Value	Current Market Value	Gain or (Loss)
A	\$ 95,000	\$104,000	
B	80,000	82,000	
C	62,000	62,000	
	<u>\$237,000</u>	<u>\$248,000</u>	<u>\$11,000</u>
	(B)	(C)	(C-B)

In this case the entry would be:

Dr.- Available-for-Sale Securities	\$11,000
Cr.- Accumulated Unrealized Gains/Losses on Available-for-Sale Securities	\$11,000

Accounting for Unit Investment Trusts

A unit investment trust is an investment vehicle that purchases a fixed portfolio of income-producing securities, such as Treasury bonds or mortgage-backed securities. Units of the trust, which usually cost at least \$1,000, are sold to investors by

broker/dealers for a sales charge which may range up to 5% of the total dollar amount of the purchase.

With a unit investment trust, investors own an undivided interest in the principal and interest portions of the portfolio in proportion to the amount of money they invest. Usually, the portfolio of securities remains fixed until all the securities mature and unit holders have recovered their principal. Most broker/dealers maintain a secondary market in the units they sell, so that the units can be resold if necessary.

Unlike mutual funds, the underlying portfolio remains fixed until all of the securities have matured. However, similar to mutual funds, a credit union cannot control the securities placed into the trust by the underwriter or the disposal of individual portfolio issues. NCUA has found in predominate practice that unit investment trusts are most often classified outside the definition of a "security" (because they do not have a determinable fair value nor are they "exchanged") and thus, are carried at amortized cost.

Put Options

Increased real estate lending by federal credit unions has led to increased risks related to the interest rate sensitivity of such loans and their longer terms. Under Part 701.21(i) of the NCUA Rules and Regulations, a federal credit union may purchase long put options on Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), and Federal Home Loan Mortgage Corporation (FHLMC) securities in order to manage interest rate risk for real estate loans produced for sale on the secondary mortgage market.

When purchasing a put option, a federal credit union acquires the right to sell a certain security at a specified price within a particular period of time. There are two parties to the put option agreement:

- a) The "holder" (the Credit Union) who, in exchange for paying an upfront fee, acquires the right to sell the security in accordance with the option contract.
- b) The "writer" (another party) who, in exchange for receiving an upfront fee, must stand ready to

purchase the security on demand by the holder, in accordance with the terms of the option contract.

Because the market value of a put option on a GNMA, FNMA, or FHLMC security may be expected to rise with an increase in market interest rates, such an option is considered "term insurance" against an increase in market interest rates from the time the rate is committed to the member during loan application to the time the loan is sold on the secondary market.

Under the regulation, a federal credit union may purchase put options if:

- a) The related loans are to be sold on the secondary mortgage market within 90 days of closing;
- b) The positions are entered into through a contract market designated by the Commodity Futures Trading Commission or with a primary dealer in government securities;
- c) The positions are entered into through written policies that meet the minimum requirements contained in the regulation;
- d) The credit union has received permission from the appropriate Regional Director to engage in options transactions;
- e) Reports must be submitted monthly to the Regional office unless waived by the NCUA Regional Director;
- f) Records must be retained for two years; and
- g) The transactions are accounted for in accordance with standards established under GAAP to the extent not inconsistent with NCUA Board instructions.

UNAUTHORIZED INVESTMENT TRANSACTIONS AND ACTIVITIES

Because of the inherent risk involved in certain investment transactions and activities a federal credit union may not:

- 1) Enter into a standby commitment to purchase or sell a security,

- 2) Buy or sell a futures contract,
- 3) Engage in adjusted trading or a short sale, or
- 4) Enter into a yield maintenance contract.

Adjusted Trading

The most common form of adjusted trading occurs when a credit union cannot meet its commitment to purchase a security on the settlement date, and the market price is below the commitment price. Thus, if the credit union is forced to immediately sell the security it will incur a loss.

To prevent the loss, the credit union would enter into an agreement to resell the security to the broker at the commitment price and to enter into another commitment to purchase a different security at a price that exceeds its market value. Thus, the credit union has deferred its loss in hopes that the market price of the security underlying the new commitment will increase by the new settlement date.

A less common form of adjusted trading occurs when a credit union swaps or exchanges a lower yielding security for a higher yielding security. In this case, the sale of the low yielding security would result in a loss, which the credit union does not wish to recognize during the current accounting period. Again, the credit union agrees to sell its security and buy the new security at prices above market. Another name for these transactions is overtrading.

A variation of the adjusted trade involving a forward commitment is known as "fee trading" or "reposition trading." This transaction is the same as the first example above except that the broker is unwilling to take the risk of purchasing the initial security. The credit union would sell at a price above market. Therefore, the broker requires that the credit union pay a fee, which is the difference in the commitment price and the market price when they enter into the transactions. When the credit union purchases the new security, the broker returns the fee. Often, this type of transaction occurs repeatedly. The fee is usually recorded by the credit union as a receivable, deferred charge, or other asset.

The above described transactions, under whatever name, constitute adjusted trading and, thus, are prohibited.

Yield Maintenance Contract

A yield maintenance contract, also known as a "pair-off" hedger, is the concurrent commitment to purchase a security via a cash forward agreement and to sell the same security on the same settlement date via a standby commitment. The credit union would be required to pay a generally exorbitant commitment fee to the vendor. The purpose of the transaction would be to "guarantee" a specified yield which is based upon the commitment fee paid. Generally, the purchase and sale prices are not related to the current market price.

Yield maintenance contracts are not permitted since they violate Section 703.110 of the National Credit Union Administration Rules and Regulations. The yield maintenance contract is an unsecured loan to a broker (a nonmember) and thus is in violation of Section 107(5) of the Federal Credit Union Act.

Stripped Mortgage-Backed Securities (IO's/PO's)

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

All IO's and PO's have highly volatile price characteristics based on changes in the prepayment pattern of the underlying mortgages and consequently on the maturity of the stripped security. Generally, IO's will increase in value when interest rates rise. Accordingly, the purchase of an IO strip may serve to offset the interest rate risk associated with mortgages and similar instruments held by a federal credit union.

Similarly, a PO may be useful as an offset to the effect of interest rate movements on the value of mortgage servicing. However, when purchasing an

IO or PO, the investor is speculating on the movements of future interest rates and how these movements will effect the prepayment pattern of the underlying mortgage collateral. Further, those SMBS's that do not have the guarantee of a federally sponsored agency (privately-issued SMBS'S) as to the payment of mortgage principal and interest have an added element of credit risk.

SMBS's have been issued by the Federal National Mortgage Association (Fannie Mae) and have also been "privately-issued" to a limited degree. NCUA has determined that SMBS's are not suitable investments for federal credit unions and therefore are impermissible investments per 703 of the NCUA Rules and Regulations.

Zero Coupon Securities

A Federal Credit Union may not purchase a zero coupon investment with a maturity date that is more than 10 years from the settlement date.

OTHER INVESTMENT CONSIDERATIONS

Investment Trading Policies

The board of directors of a federal credit union that intends to engage in securities trading should develop and adopt a written trading account policy that includes, at a minimum, the following provisions:

- a) Individuals who have purchase and sale authority;
- b) Trading account size limitations;
- c) Allocation of credit union's cash flow to trading accounts;
- d) Stop-loss or sale provisions;
- e) Dollar-size limitations of specific types, quantities and maturities to be purchased;
- f) Monthly market price adjustments;
- g) Limits on the length of time an investment may be inventoried in the trading account;

h) Monthly reports to the Board of all purchase and sale transactions and the resulting gain or loss to be reported on an individual basis. Purchases and sales shall be reported at trade date;

i) A prohibition against the use of a broker/securities dealer in purchase or sales transactions unless, prior thereto, the credit union has in its files evidence of the broker/dealer's financial responsibility and capability, and management has made reasonable inquiries concerning the broker/dealer's reputation;

j) A requirement that any security purchased for trading purposes will be recorded at market value on the trade date; and

k) Requirements with respect to securities transfers between the credit union's investment and trading accounts:

1) The securities being transferred shall be revalued to the current fair value;

2) Any adjustment in connection with transfer of a security shall be accounted for consistent with GAAP.

3) No transfers shall be made between categories unless transfer of the security is consistent with previously established investment portfolio policies and objectives. Such transfers are unusual and should be rare.

Responsibility

The board of directors is responsible for the investment of credit union funds in accordance with Section 113 of the Federal Credit Union Act (Act). In general, these investments are limited to those authorized by Section 107(7), 107(8) and 107(15) of the Act. Additionally, Part 703 of the National Credit Union Administration Rules and Regulations and various NCUA Interpretive Ruling and Policy Statements impose additional limitations and/or requirements.

The board of directors must establish policies and procedures to ensure that the credit union's overall financial objectives are being met and that the

investment program will provide adequate liquidity, safety and yield to the credit union. To achieve these goals, the board will need to give attention to the following investment considerations:

A federal credit union's ability or inability to make a quick decision to purchase or sell an investment could result in a gain or loss of thousands of dollars. By the same token, a quick decision to invest in a security or enter into a transaction that management does not understand could result not only in potential losses, but also long-term liquidity problems. Additional information and guidance relative to sound practices for managing the risks of investment activities is contained in NCUA Interpretive Ruling and Policy Statement No. 98-2; *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities*.

A sound investment policy facilitates purchases and sales of securities while assuring their safety. Each security, investment and type of transaction should be analyzed, approved by the board of directors and formally addressed in the investment policy manual. The investment policy should consider the following:

a) U.S. Government and federal agency securities vary in guarantee, yield, interest rates and maturities. Some may not meet the overall needs and objectives of the credit union. The investment policy should list disapproved, as well as approved investments. Any new issue should be presented to the board with an appropriate prospectus and background information before decisions are made.

b) Shares, deposits, or investments in savings and loan associations, banks and credit unions may present a risk not generally recognized, especially when investments exceed insured limits. A thorough review of these institutions' financial statements before investment should disclose any undue risk, and periodic review after the investment should be required. The manual should also specify any limitation or restriction of these investments.

c) All other investments should be reviewed on an individual basis and cited in the investment policy. A sound investment policy addresses the need to facilitate purchases and sales of securities and to enter into safe investment transactions. In many credit unions, this means delegating the

responsibility for individual approvals to either an executive or investment committee. This should be done carefully. The right to delegate is not the right to abdicate. Clear written guidelines outlining the delegated authority will ensure that the board's policies are carried out.

In some cases, an individual may be authorized to invest or divest funds in specific investments on a continuing basis, such as in a common trust whenever the checking account balance is in excess of a specified balance. Additionally, an individual may be assigned to advise a broker of the board's decision to purchase an investment or to sign documents. Investment policy should make clear that these responsibilities are not a "carte blanche" authorization to invest credit union funds.

The type of funds management employed by a credit union depends upon its size, resources, volume of activity, and management expertise. Generally, the more detailed the concept, the better control the credit union has over its ability to meet member needs.

Special Considerations

There are certain factors which must be considered when integrating investment policy into overall goals and objectives. These factors are safety, liquidity, and yield.

Safety

Despite being limited by law to investments that are primarily guaranteed as to principal and interest, certain investment risks do exist for Federal credit unions. These risks include:

- a) *Market risk* - a possible reduction in value resulting from changes in market demand.
- b) *Interest rate or maturity risk* - a possible reduction in value resulting from increases in interest rates.
- c) *Credit risk* - a possible loss if the issuer of an investment defaults. (This could result from imprudent investments in savings and loan associations and banks in excess of insured limits, or investments in credit unions.)

d) *Price-level risk* - a possible reduction in purchasing power of the dollar as a result of inflation.

Federal credit unions can reduce investment risks by fully evaluating each type of investment prior to purchase, including the issuer, analyzing the financial condition and reputation of any intermediary to the transaction, such as a broker/dealer; and diversifying the investment portfolio by type, maturity, geographical location, guarantor, etc.

Liquidity

Investment policy must be flexible enough to allow for changes in the balance sheet items that represent member needs, i.e., shares and loans. As such, investment practices can be considered a function of share and loan behavior. Each time there is a shift in either share or loan volume, there may exist a need to shift investment strategy.

Suppose, for example, the board of directors decides to expand loan policies by offering longer term loans to meet member needs. This will result in a slower turnover of funds, and thus will expand the loan portfolio. If share deposits cannot be expected to meet the increased loan demand, investment policies must reflect a change. In this case, the credit union would probably shorten investment maturities to meet the expected loan demand.

Another factor which would affect Liquidity is the movement and direction of interest rates. As they increase, the value of long-term securities decreases. Thus a credit union with long-term securities during a period of increasing interest rates would become illiquid unless the loss incurred through their sale could be absorbed.

Yield

Only after liquidity and safety are considered should investment analysis center on yield. As a general rule, investments with higher risk factors and greater price volatility command the greater yield. Thus the potential for greater income must be weighed very carefully against the risks of reduced liquidity and/or potential losses.

Authorized Broker/Dealers

The credit union's investment policies should identify all institutions and dealers/brokers with whom the board of directors and/or investment committee/officer are authorized to transact investments. Approval of institutions and dealers/brokers should be preceded by a thorough analysis of their financial stability, services provided, responsiveness, and reputation. The credit union should formalize its relationship with investment institutions and specifically identify which credit union officials are authorized to transact credit union investments. Contractual arrangements with investment institutions should be reviewed at least annually.

Reporting Requirements

The investment policy should specifically state the types of reports required by the board to make investment decisions. These reports may include a summary of investments by type, maturity, size, market values or concentration. Additionally, executive and/or investment committees should prepare a monthly list of all investments which they authorized and any significant occurrences during that period.

Internal Controls

The investment policy should require that adequate internal controls are established to separate the responsibilities for approving, disbursing, reconciling and accounting for investment activities. A flow chart depicting these responsibilities may be needed.

Surety Aspects

The investment policy should give consideration to the maximum amount of coverage and other possible limitations contained in the surety bond. However, the board should not rely on the expectation of surety coverage as a substitute for sound and prudent investment policies.

Safekeeping

The board should establish investment policies which will protect securities held in safekeeping. The policies require that:

- a) All securities not in the physical possession of the credit union should be held in a third party (a bank or other financial institution) safekeeping account. A separate trust division of a bank acting as a dealer qualifies as a third party safekeeping institution.
- b) In establishing a safekeeping account, cost and service should be considered. The broker's bank may be used for safekeeping services. However, safekeeping agreements should provide that all transactions will be ordered only by a duly authorized employee or official of the credit union. If the safekeeping institution is to be used to transmit credit union funds for purchases of securities, the agreement should provide that the funds will not be transferred until the securities are received by the institution.

Safekeeping services should be covered by a "safekeeping agreement". Under this arrangement, the institution, for a fee, agrees to exercise ordinary care in protecting the securities held in safekeeping. Unless specifically covered by statute or contract, the institution is not an insurer of the securities. It is liable only for negligence in caring for and protecting the securities.

Periodic Review Policy

The investment policy should be reviewed by the board of directors at least annually. This should ensure that policies and procedures are kept current and that the officials remain in control of the investment program.

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LOANS HELD FOR SALE

This account represents loans held-for-sale which must be classified separately from other loans. Mortgage loans held for sale are reported on the financial statements at the lower of cost or market value. Mortgage-backed securities are reported and classified as securities (See Investment section). However, a credit union must classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process. Loan origination fees and related direct loan origination costs for loans held for sale shall be capitalized as part of the carrying amount of the related loan and shall not be amortized.

Credit unions should be aware there are special generally accepted accounting principles with regard to acquiring mortgage servicing rights (MSR) and

servicing of mortgage loans. A full discussion of MSR is beyond the scope of this Manual.

LOANS RECEIVABLE

This account represents the total amount outstanding in loans receivable from members and is a summarization of all the individual loan ledgers for that particular type of loan. Totals of the balances of the individual loan ledgers must be taken at the end of each month to insure that they are in balance with this General Ledger control account. Particular attention should be given to the discussion and requirements of the NCUA Rules and Regulations.

Loan origination fees and related direct loan origination costs for loans held for investment shall be deferred and recognized as an adjustment to yield. Loan commitment fees shall be deferred and

recognized over the life of the loan or until the loan is sold, while fees paid to permanent investors shall be recognized as expense when loans are sold. Fees for services performed by third parties and loan placement fees are recognized as revenue when all significant services have been performed.

LOANS RECEVABLE BY TYPE

Consumer Loans

This account includes loans made to members for consumer type expenditures such as automobiles, trucks, motorcycles, recreational vehicles, household goods, home improvements, revolving credit, medical expenses, vacations, taxes and similar items. Revolving credit loans would also be included in this account. Many credit unions, through use of their computer systems, are able to keep records on the various types or purposes of loans to reflect the number and balances outstanding in each category for comparison purposes. The credit union needs to keep detailed subsidiary records of individual loans granted and/or outstanding by loan types. The subsidiary records should be subtotaled, the total of the balances should be proved with the balances in this account at least monthly, and the listings retained in the files.

Business (Commercial) Loans

Commercial or business loans are generally defined as having the following characteristics: (1) repayment will be made from business revenue, (2) the security is a business asset, (3) the purpose is to obtain a business or business asset, or (4) the proceeds will be used to finance a business operation. Specific requirements have been established in the NCUA Rules and Regulations. A federal credit union may make business loans only in accordance with all the provisions of the regulations. The credit union staff must have the expertise required to protect against losses which could result. Since most business loans are larger, the risk of losses is much greater. With this type of loan, the emphasis on underwriting such loans shifts from the individuals, as in a regular consumer loan, to the financial soundness of the business requesting the loan.

The loan should be supported by commercial credit reports, analysis of income and expense statements, cash flow and balance sheet analysis. Cash flow is often a problem for most small businesses. Considering the high percentage of new business that fail, additional collateral should be considered in financing a new business by the credit union. If inventory is taken as collateral, it should be recognized that upon forced sale, the value of that inventory may only be a fraction of the value of this finished product.

Agriculture Loans

The same specific requirements for business loans contained in the NCUA Rules and Regulations are required for agriculture loans. A credit union making agricultural loans must take into account various factors that may not be present in considering urban real estate as security on loans. Loans are made not on the acreage alone, but upon the productivity of those acres. Erosion and wastage as well as fertility must be studied since the loan may be repaid over a long period of time. Productivity of the farm over a series of years as a source of repayment must be considered since it must first provide a living for its owners. The lender must be sure there will be funds to pay taxes and operating expenses, including reasonable allowances to maintain the productivity of the land, and still leave a balance to amortize the loan. The applicant must be able to demonstrate managerial efficiency.

Accounting records are needed to supply information on the ability of the borrower to repay. Net worth should be used in determining borrowing capacity, but only cash can repay the debt. Income statements are more useful in measuring debt repayment capacity. Tax returns are also essential to determine information on the potential borrower. If crop loans are made, inspections of the growing crops are essential as well as monitoring of disbursements to assure that the proceeds are channeled into the farmer's operation. Livestock loans need inspections at the inception of credit as well as periodically throughout the life of the loan, and the inspections should be documented in the loan files. For example, a loan for a dairy herd purchase would need a detailed written inspection periodically to

determine if the cattle are healthy and productive at all times. The inspection would determine if the value of the cattle is adequate to repay the outstanding loan based on market conditions. Likewise, a loan to finance a calf feeder operation would also need periodic inspections to determine that all the livestock purchased were healthy and increasing in value to repay the loan at maturity. These inspections will take expertise which may or might not be readily available in the individual credit union.

Other Member Loans

This account contains various loans to members which do not fit other groupings listed. Included in this account may be investment loans, student loans, and other loans as needed.

Home Equity Loans

A loan gaining wide acceptance in credit unions is the Home Equity loan. These loans may offer a tax benefit to members who itemize deductions for tax purposes. This type of loan plan allows the borrower to use the portion of equity in his/her residence to increase borrowing capacity. These loans can either be first or second mortgage loans.

Although credit unions should employ the same procedures and evaluation of creditworthiness and collateral as in other real estate lending, home equity loans are often different since they may be open-end loans. Advances can be generated in a variety of ways as in any open-end plan.

Credit unions need to develop extensive policies when engaging in home equity lending and should have similar procedures as with traditional real estate loans. A policy on the maximum percentage of appraised value that will be loaned (including unpaid value of the first mortgage plus the maximum loan limit on the second mortgage), proper and accurate written appraisals of the collateral, and detailed evaluation of the applicant's ability to repay are all needed. The loan must comply with provisions contained in Section 701.21 of the NCUA Rules and Regulations as well as other legal requirements where the credit union is located. It is extremely important that legal counsel be consulted so that any

problems detected in the loan documents can be alleviated. An attorney's opinion should be on file stating the forms meet all applicable federal, state, and local requirements. Even with the opinion letter from the vendor's attorney, it would be wise to obtain an independent attorney's opinion from an individual who specializes in state law.

Advantages of these types of loans are that the loans are often granted at variable interest rates and are secured by collateral that can often appreciate rather than depreciate. Also, they can be made with relative ease of disbursement after all initial documents have been prepared and can be modified depending on external factors such as the loan demand.

Disadvantages include the fact that real estate market values may decrease in value, or the property value may decline due to poor maintenance. Also, if this type of lending is not controlled, it could have the impact of overextending the borrower to possible bankruptcy. This type of loan also contributes to a lower loan turnover rate and must be managed from a liquidity and funds management standpoint.

Entries In Journal And Cash Record

The accounting for all types of loans in this series of accounts is basically the same. Debit these accounts in the "Loans-Loaned" column of the Journal and Cash Record with the full amount of new or refinanced loans made to each member. Credit these accounts in the "Loans-Repaid" column with the total of cash payments of principal made by borrowers and endorsers, the balance of old loans included in new or refinanced loans, the application of shares to loans, and the charge-off of uncollectible loans.

Entries canceling loan principal payments because of dishonored checks should be recorded in the "Loans-Repaid" column as deductions by entering the amounts involved in red figures or parentheses.

Posting To General Ledger

Debits and credits to these accounts in the General Ledger are made at the end of each month by posting

the totals of the "Loans" columns from the Journal and Cash Record.

Posting To Members' Accounts

The items which are accumulated in the "Loans Loaned" column of the Journal and Cash Record for monthly postings to the General Ledger Loan accounts are also recorded in the Individual Share and Loan Ledger and in the Member's Passbook or Statement of Account. Credit entries for payments made on the loans are posted in these records from the Cash Received Vouchers or equivalents; other credit entries are posted from the "Loans-Repaid" column of the Journal and Cash Record.

Entries showing the charge-off of a loss loan should be identified as such in the member's account in the Individual Share and Loan Ledger. Recoveries on loans charged-off should be recorded as memorandum information on the member's account, or on a work sheet.

The total of the individual loan accounts as shown in the Individual Share and Loan Ledgers needs to be proved with the total of the loans in the General Ledger at least monthly and the listing (adding machine or computerized trial balance) retained in the files.

Illustrative Entries

- a) When a loan is made to a member:

Dr.- Loans	\$100.00	
Cr.- Cash		\$100.00

- b) When an installment on a loan is paid and interest and late charges are collected:

Dr. - Cash	\$11.20	
Cr. - Loans		\$10.00
Cr. - Interest on Loans		1.00
Cr. - Fees and Charges		.20

- c) When a member having a note outstanding with an unpaid balance of \$10.00 gives a new note for \$50.00 and receives a check for \$40.00 and his old note:

Dr. - Loans	\$50.00	
Cr. - Cash		\$40.00
Cr. - Loans		10.00

Note: If a Journal Voucher is used, the new loan should be entered as a debit for the gross amount, the old loan balance as a credit item, and the voucher should indicate the net cash paid in the space opposite "Amount" in the lower left side of the form.

- d) When a member authorizes the credit union to apply his shares to his indebtedness:

Dr. - Shares	\$50.00	
Cr. - Loans		\$49.00
Cr. - Interest on Loans		1.00

- e) The board of directors determines the loan to the member may be a potential loss due to announced bankruptcy proceedings. The Allowance for Loan Losses Account is increased to provide for full and fair disclosure requirements of Section 702.3 of the NCUA Rules and Regulations.

Dr. - Provisions for Loan Losses	\$25.00	
Cr. - Allowance for Loan Losses		\$25.00

- f) When the board of directors determines that further collection cannot be effected on a loan and authorizes charging off the loan:

Dr. - Allowance for Loan Losses	\$25.00	
Cr. - Loans		\$25.00

Note: Only the unpaid principal should be charged-off. If the member has any shares, the shares should be applied to the loan before the charge-off, provided the credit union has obtained the proper statutory liens in court.

Detailed Transactions

Debit:

a) With total principal amount of new and refinanced loans made to members.

Credit:

a) With cash payments of principal made by borrowers and endorsers.

b) With unpaid principal balances of loans included in new and refinanced loans.

c) With amounts of shares applied to principal of loans.

d) With the unpaid balance of loans transferred to "Loans-Collateral in Process of Liquidation".

e) With the charge-off of loss loans.

LOANS-COLLATERAL IN PROCESS OF LIQUIDATION

The account reflects the total unpaid principal balances of all loans for which the credit union has taken possession of collateral, by legal process or otherwise, and for which the obligation of the borrower has not been canceled. Transfer of the unpaid balance of the particular loans secured by the acquired collateral should be made to this account. If the borrower has other loans outstanding, notations should be made on all his ledger cards to indicate the transfer to this account, but loans of the borrowers not related to the acquired collateral should remain in "Loans".

The purpose of the transfer to this account is to segregate the loan balances for control and accountability and to permit realistic financial analysis of these loans. This account may include costs incurred in acquisition or disposal of collateral related to loans in this account if the loan instrument or other written agreement allows the credit union to add such costs to the borrower's loan balance.

When the borrower's obligation to the credit union has been canceled, by legal requirement in some jurisdictions or by some action of the board of directors, the assets in possession of the credit union

should be accounted for in "Assets Acquired in Liquidation of Loans."

Illustrative Entries

a) To record the transfer of the unpaid principal balance of loans for which assets have been acquired by the credit union:

Dr. - Loans - Collateral in Process of Liquidation	\$350.00
Cr. - Loans	\$350.00

b) When the borrower's obligation to the credit union is canceled, to transfer the value of the fair value of the collateral asset to Assets Acquired in Liquidation of Loans:

Dr. - Assets Acquired in Liquidation of Loans	\$300.00
Cr. - Loans - Collateral in Process of Liquidation	\$300.00

c) The \$50.00 remaining in Loans- Collateral in Process of Liquidation may be charged-off to Allowance for Loan Losses at this time with authorization of the board of directors. If the board of directors had not previously established the \$50 in the Allowance for Loan Losses Account, it should be authorized at the time of the charge-off of the designated loss amount.

Dr. - Allowance for Loan Losses	\$50.00
Cr. - Loans - Collateral in Process of Liquidation	\$50.00

Detailed Transactions

Debit:

a) With the principal balance of loans secured by collateral acquired by the credit union.

b) With costs incurred in acquisition or disposal of collateral when such costs are legally proper for charge to the borrower's loan balance.

Credit:

- a) With cash payments of principal made by borrowers or endorsers.
- b) With the amounts of shares applied to principal balances.
- c) With the unpaid balances of such loans when the value of the collateral is recorded in "Assets Acquired in Liquidation of Loans".
- d) With charge-offs of loss loans.

PASSBOOKS

For those (few) credit unions still using passbooks, members should be encouraged to present the passbooks for each transaction. If a transaction is not entered in the member's passbook because the passbook is temporarily not available, a temporary passbook or cash received voucher/receipt should be provided. The member should be instructed to present his passbook for entry as soon as practicable. If the passbook is lost, a duplicate should be issued after the member has provided adequate identification.

Entering Member Loans on the Records

For each loan made to members a Journal Voucher should be prepared showing the name of the credit union, the member's account number, the date the check is issued, and the name of the borrower. The amount of the loan is shown in the debit column opposite "Loans" and the amount of the check is entered in the credit column opposite "Cash". The notation "credit committee" or "c/c", or the name of the loan officer, is written in the spaces provided. When the check is delivered to the borrower he/she should, if practical, sign the voucher at the bottom opposite "Received By."

The loan should also be entered in the member's passbook or statement of account. Under the "Loans" section of the passbook, the date of the loan, the amount loaned, and the balance are written and initialed by the authorized credit union official who made the entry. The passbook is then returned to the member with the check.

The loan should be entered in the Journal and Cash Record. The date, borrower's account number, borrower's name, note number, and check number should be entered in the appropriate columns. The amount of cash shown on the check should be entered in the credit column under "Cash-Paid Out." A similar amount should be entered in the debit column under "Loans." If it is a refinanced loan, the amount entered in the debit column should be the amount shown on the check plus the unpaid balance of the loan being refinanced.

Each disbursement for a loan should be posted individually from the Journal and Cash Record or a Journal Voucher to the Individual Loan Ledger of the member. A loan made is entered on a line opposite the date, which has been written in the "Date" column headed "Amount Loaned." The same amount is carried over and entered in the "Balance" column. The note number is entered in the column headed "Note No." Under the column headed "Post Ref" is written the page in the Journal and Cash Record from which the entry is posted, such as "JC 1." When the item is posted, a checkmark should be placed in the checkmark column () of the Journal and Cash Record or in the space opposite "Posted" on the Journal Voucher.

The "Cosigner on Notes of Others" section of the Individual Share and Loan Ledger is used to show the member's liability for having signed as a co maker or endorser on another member's note. If there are any co makers on a note who are members of the credit union, it is essential that their liability be recorded. This information need not be shown on the Individual Share and Loan Ledger if a supplementary record is maintained.

When a member has a loan outstanding and is granted a second loan the new loan should be entered on a separate Individual Share and Loan Ledger. A separate Cash Received Voucher should be prepared to reflect repayment on each loan and the voucher should identify the specific loan to which the payment applies.

Maintaining the Note Record on the Individual Share and Loan Ledger

The use of the "Note Record" at the top of the standard Individual Share and Loan Ledger is optional if the "Delinquency Control" or another control record is maintained. It is recommended that each note be recorded here so that it will not be necessary to refer to the note itself to determine the terms of repayment.

Maintaining the Delinquency Control on the Individual Share and Loan Ledger

The standard Individual Share and Loan Ledger contains two columns which are designated as "Delinquency Control." Although the maintenance of the "Delinquency Control" is optional if the "Note Record" or another control method is kept, it does provide a method for a quick analysis of the loans for the purpose of determining whether they are delinquent and, if so, the extent of such delinquency.

WHEN PAYMENTS ON LOANS ARE RECEIVED

Collection of Interest

Interest is usually collected at the time a repayment on principal is made. Interest rates and finance charges may not exceed the maximum rate permitted by the Federal Credit Union Act.

Interest may be calculated and collected on either a 360- or 365-day basis per year. Further information on these two bases of computing interest is presented in the following paragraphs. Applied uniformly, the true annual interest rate is 15 percent for the interest charge of 1.25 percent per month on the unpaid balance, whether the 365-day year or a 360-day year (30-day month) method is used. Whichever method is used it must be used exclusively.

A mixture of the two methods on a loan between disclosure and actual entered collection *could* result in an improper interest charge (i.e., 365 day computation of interest for disclosure purposes and a 360-day computation for the note and actual collection of interest). Under the 360-Day Method, if a month such as February has only 28 days, the borrower is charged 30 days of interest. Because of

the increased accuracy of 365-Day Method, it is recommended that this method be used in calculating interest charges and repayment amounts.

365-Day Year Method

Interest charges based upon a 365-day year can be applied to all repayment contracts, whether written for weekly, biweekly, semimonthly, monthly or other terms. Interest should be computed on the basis of the actual number of days elapsed since the last date through which interest was previously paid or if it is the first payment, since the date the loan was granted. If daily interest factors are developed to aid in computing interest, they must be based upon a 365-day year.

30-Day Month Method (360-Day Year)

This method may be advantageous for those credit unions which make loans based upon monthly repayment terms, or fractions or multiples of monthly repayment terms. The most popular of these repayment terms is the loan calling for payments on the same date each month; other terms call for payments semimonthly or annually. If factors are developed to aid in computing interest on the basis of a 30-day month, they must be based on 360 days (30 days times 12 months).

When applying the 30-day month method, each month is considered to have 30 days regardless of the actual number of days in the month. For instance, under this method, March is considered to have 30 days even though it actually has 31 days. If payments are made on the same date each month, one month's interest charged regardless of whether the month that has elapsed actually had 28, 29, 30, or 31 days.

When payment is made before a full month has elapsed, interest is charged for the exact number of days (based on the 30-day month). As an example, if a payment was made on March 12 and the next payment is made on April 5, interest would be charged for 23 days (23/30ths) (31st of March is not counted).

When more than one full month has elapsed since the previous payment, interest is charged for the full

month(s), plus the additional days (computed similar to the instructions in the previous paragraph). As an example, if payment on a loan was made on March 29 and the next payment is made on June 4, interest would be charged for two full months (March 30 to May 29), plus 5 days (May 30, June 1, 2, 3, 4) (31st of May not counted) or (65/30ths).

Grace Period

To ease the task of computing interest, the board of directors may permit a grace period of up to seven days following the due date of each payment. No late charges or additional interest charges are assessed if the payment due is received during that period.

Accrual of Interest

Interest on a loan should begin to accrue upon the disbursement of the loan proceeds. Where the borrower's principal residence (or property which is expected to be used as the borrower's principal residence) is to serve as security for a loan (except for related first mortgage loans), the loan proceeds should not be disbursed until it is determined that the borrower does not intend to rescind that transaction as provided by Regulation Z. When loan drafts are involved, the question arises whether a credit union incurs a liability at the time authorization is issued for a draft to be drawn upon it or whether no liability exists until the draft is accepted. The influencing factors are of a legal nature and may vary in different jurisdictions; the credit union is advised to seek advice from its attorney in determining when the draft becomes a loan and when the interest begins to accrue.

METHODS OF CALCULATING INTEREST

United States Rule-Simple Interest

Under the United States Rule, a loan payment must be applied to the accumulated interest up to the date of the payment. Any remainder is then credited as a deduction from the principal; successive interest is computed from a declining unpaid balance each time a loan payment is made. If a payment is not sufficient to meet the simple interest which has accrued during the elapsed payment period, such

shortfall of interest will be met from subsequent payment or repayments. If a loan payment is insufficient to cover the interest due, the balance of the interest is not added to the principal so as to produce interest.

Level Payment

This method of repaying a loan involves payment of equal installments that consist of principal and interest over the life of the loan. As the loan matures, payments to principal become greater as interest charges become smaller.

Principal Payment Plus Interest

Repayment of a loan following this method involves equal payments to principal while interest payments are larger during the early stages of the loan and become smaller as the principal balance declines. An advantage of principal plus interest is its ease in the computation of delinquency. A possible disadvantage is that the total loan payment differs from one payment to the next.

Rule of 78

Federal credit unions are not allowed to charge a penalty for the early payoff of a loan. (See Federal Credit Union Act, Section 107(5).) Since the use of the Rule of 78 may result in a penalty being charged to the member, the computation of loan interest using the Rule of 78 may conflict with the law.

Actuarial Method

The actuarial method involves the compounding of interest when a loan payment is greater than a unit period (the period established in the contract for regular payments). The actuarial method requires the addition to the outstanding principal balance any shortfall of interest which occurs at a payment period.

Interest Rates in Relation to Different Classification of Loans

The board of directors has the power to establish interest rates for loans (including lines of credit) based on written classifications established by the board. Classifications should be based upon factors

that achieve a sound and legitimate business practice. Examples of lending policies which achieve this are illustrated below:

a) Real Estate Loans

A federal credit union with a large field of membership is granting real estate loans to members located in different areas of the United States. The board of directors could establish a policy to achieve competitive interest rates within local real estate markets. Example policy: Conventional long-term real estate loans originated in city A will be granted at X % and in city B, at Y %.

b) Amount Of The Loan

The board of directors desires to establish interest rates based on the amount of the loan. Example policy: all unsecured loans with balances not exceeding a specific amount will be granted at X% and all unsecured loans exceeding the specified amount will be granted at Y%.

c) Maturity Of The Loan

A board of directors may desire to match loan maturities/interest rates to corresponding share certificate maturities/dividend rates. The board of directors could establish the following policy. Example policy: All loans with maturities not exceeding 6 months will be granted at X% and all loans with maturities exceeding 6 months will be granted at Y%.

d) Method Of Payment

A board of directors of a federal credit union which has documented cost evidence of an administrative savings for loans repaid via payroll deduction, direct deposit, or transfer from a share account may establish a policy to pass this savings on to the borrowers. Example policy: All loans repaid via voluntary payroll deduction will be granted at X% and all loans repaid by other means will be granted at Y%.

e) Sound Social Policy (Cooperative Spirit)

A board of directors could establish a policy to promote energy conservation. Example policy: All loans secured by automobiles which have an EPA estimated miles per gallon rating of 25 or more will be granted at X% and other loans secured by automobiles will be granted at Y%.

Any interest rate established within a loan classification should be consistent with cooperative principles and existing laws and regulations. Proper use of this power could reduce the operating cost to the credit union and allow the board of directors to better manage the loan portfolio. In addition, the borrower can benefit from the varying interest rates.

Repayment Plans

There are a number of repayment plans, any of which a credit union may use. The most common loan repayment plans are weekly, biweekly, semimonthly, and monthly. It may be convenient for some credit unions, such as educational groups to offer a skip payment plan. The terms of repayment and APR must be properly disclosed. Credit unions are also authorized to offer single payment loans; specific requirements are contained in the NCUA Rules and Regulations.

When a Loan is Refinanced

A loan is refinanced as the result of a new transaction whereby a former loan is replaced by a new loan under the parties' contract and applicable law. The refinanced loan may involve the consolidation of several existing loans, disbursement of new money to the borrower on the borrower's behalf, or the rescheduling of payments under the existing loan. In any form, the new loan must completely replace the prior one in order to be considered a refinanced loan. The mere addition of the accrued interest to the outstanding balance of any existing loan balance would not in itself constitute a refinancing. Loans should not be refinanced or extended for the purpose of eliminating them from the delinquent list.

When a loan is to be refinanced, application should be made in an amount sufficient to repay in full the balance of the outstanding loan plus the additional

amount of cash desired by the member. The proper entry is illustrated in the third illustrative entry in the description of "Loans." Payment of interest is not shown in this entry since the collection of accrued interest due from the member can be handled by one of the following alternatives:

- a) correct the interest due in cash as a separate transaction;
- b) include it in the amount of the new loan, or
- c) defer it until the time of the first payment under the new obligation interest to be paid in conjunction with the first payment and not deducted from it.

Under alternatives (a) and (c), no Truth in Lending disclosures are required for accrued interest payments; alternative (b) requires Truth in Lending disclosure in the normal manner (as part of the loan proceeds). The accrued interest in alternative (b) must also be disclosed in the note form (contract).

When a Loan is Extended

Extension means amending or supplementing the terms of the original note to achieve a reduction in the original contracted note's scheduled or systematic repayments without supplying additional money. The change in the original terms of the loan would not be subject to disclosure requirements of Truth in Lending Regulation Z.

An extension agreement should be treated in the same fashion as a note. It should be typed or prepared in ink (signed by the borrower in ink). If an error is made on the agreement, a new one must be prepared. Regulations of the Federal Housing Administration prohibit the extension of the maturity of an insured Title I Property Improvement Loan.

When a Loan is Deferred

Deferral means a temporary interruption of the established systematic repayment schedule which involves one or more full payments with no change in the existing terms of the loan, and in which no charge is made other than the additional interest which would accrue on the unpaid balance. The interest is calculated by applying a stated percentage

to the unpaid monthly loan balance. A deferral, as defined, will not require additional disclosures under Regulation Z. A deferral must be supported by a written acknowledgment obtained from the member; it must be approved by the credit committee or loan officer and all co-applicants and/or co-makers.

Assessment of Late Charges

Article XII of the Standard Federal Credit Union Bylaws provides for the assessment of late charges. Subject to the limitations of applicable law and regulations, any member whose loan is delinquent may be required by the board to pay a late charge.

In the event a periodic late charge is waived, the credit union can only assess a late charge on that portion of the total outstanding interest that represents the interest that has accrued since the last payment was made. It cannot assess a late charge based on a percentage of the total outstanding interest.

Troubled Debt Restructuring

Troubled debt restructuring results when the credit union grants concessions to the member that would not ordinarily be granted in light of the member's financial condition. Restructuring often involves a reduced interest rate, payment amount, or principal amount; or increased collateral requirements. Routine changes in debt terms and loan deferrals (temporary interruption of payments which change only the maturity date) are not considered troubled debt restructurings.

There are two primary types of restructuring:

- (a) a transfer of assets from a member to the credit union in settlement of a debt and
- (b) a modification of terms.

Whatever the form of concession granted, the object is to increase the probability of recovering the loan. In this regard, the credit committee and loan officers should fully understand the member's needs and financial condition before approving actions to modify loan terms. Some credit unions may require that members make several payments in accordance with the proposed loan terms to assure they will be

able to comply with these new terms. During this interim period, the loan should remain delinquent. After several payments are made in accordance with the proposed modified loan terms, proper actions can be taken based on a complete evaluation of the member's financial condition and collateral.

In addition to evaluating the member's financial condition, the credit committee or loan officer should determine the current value of any collateral securing the loan. The credit committee or loan officer must determine that the restructured loan maturity is not extended beyond the useful life of the collateral and that additional collateral is obtained if needed.

Transfer of Assets in Settlement of Debt

A credit union may accept assets from the member in partial or full satisfaction of a debt, such as in the case of a repossession or foreclosure. If receipt of the asset is considered full satisfaction of the debt, the credit union should record the asset at fair value, reducing the balance of the debt accordingly. If the fair value of the asset is less than the balance of the loan, the excess should be charged-off to the *Allowance for Loan Losses* account. After restructuring the debt, the credit union should account for the assets as if they had been acquired for cash. Gains and losses on the sale should be recorded in the current period income statement.

Illustrative Entries

a) If the asset value exceeds the balance of the troubled loan:

Current principal balance	_____	\$7,397
Delinquent interest (3 months)	___	103
Fair value of asset	_____	8,000

The restructuring would be recorded as follows:

Dr. - Assets Acquired	\$8,000	
Cr. - Loans	\$7,397	
Cr. - Income from Loans	103	
Cr. - Payable to the Member (return may be required by loan contract terms or law of jurisdiction)		500

b) If the balance of the troubled loan exceeds the asset value:

Current principal balance	_____	\$7,397
Delinquent interest (3 months)	___	103
Collateral Value	_____	6,000

The restructuring would be recorded as follows:

Dr. - Assets Acquired	\$6,000
Dr. - Allowance for Loan Loss (ALL)	1,397
Cr. - Loans	\$7,397

Note: Neither current nor deferred income is recognized in this case.

c) If the asset were later sold for \$8,000 cash:

Dr. - Cash	\$8,000
Cr. - Assets Acquired	\$6,000
Cr. - Gain on Disposition of Assets	2,000

d) If the asset were later sold for \$5,000 cash:

Dr. - Cash	\$5,000
Dr. - Loss on Disposition of Assets	1,000
Cr. - Assets Acquired	\$6,000

Modification of Terms

A modification of terms may consist of any or all of the following:

- Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt;
- Extension of the maturity date at a stated interest rate lower than the current market rate for new debt with similar risk;
- Reduction (absolute or contingent) of the principal amount or maturity amount of the debt; or

- Reduction (absolute or contingent) of accrued interest.

The result of restructuring through modification of terms is essentially a replacement of the old loan on the books. No special accounting is required unless the total future cash receipts specified by the new terms of the loan (including both interest receipts and principal receipts), are less than the recorded receivable before restructuring. In this case, the recorded balance should be reduced with the excess amount charged-off as a loss.

Illustrative Entries

- a) Suppose the present value of future cash receipts equals the current principal balance plus delinquent interest:

Current principal balance	_____	\$7,397
Delinquent interest (10 months)	___	103

New loan terms:

Payment	_____	\$260
Interest	_____	15%
Term	_____	36 months
Present Value	_____	\$7,500

The new loan would be recorded as follows:

Dr. - Loans	\$7,500	
Cr. - Loans		\$7,397
Cr. - Accrued Interest on Loans		31
Cr. - ALL		72

This entry records the new loan principal balance of \$7,500 which equals the old loan principal balance plus delinquent interest. This entry also reverses the accrual of income (assuming the permissible accrual equal to three months of the delinquent interest (\$103 times 3/10 equals \$31)) and reduces the amount of loan provision (bad debt expense) necessary for the period by increasing the *Allowance for Loan Losses* by the balance of the remaining delinquent interest (\$103 minus \$31 equals \$72) to be recognized over the remaining life of the loan. The present value of the future loan payments equals

the new loan balance; therefore, no adjustment to the new loan balance is required.

- b) Suppose the present value of future cash receipts is less than the current principal balance:

New loan terms:

Payment	\$250
Interest	15%
Term	36 months
Present Value	\$7,212

Because the present value of these future cash payments (\$7,212) is less than the current principal balance (\$7,397), the difference (\$185) must be charged-off as a loss, and no current or deferred income would be recognized. In addition, the three months of permissible accrued interest on a delinquent loan (assuming it had been booked) must be charged-off:

Dr. - Loans	\$7,212
Dr. - ALL	216
Cr. - Loans	\$7,397
Cr. - Accrued Interest on Loans	31

Combination Restructuring

If the restructuring involves a receipt of assets in partial settlement and a modification of terms, the loan is first reduced by the fair value of the assets received, then the new loan is recorded in accordance as described above. No loss is recognized unless the balance after recording the fair value of the asset exceeds the present value of future cash receipts under the modified loan terms.

Capitalizing Delinquent Interest

Troubled loans are likely to have delinquent interest at the time of restructuring. In these cases, assuming the credit union has accrued and recognized the permissible three-months interest, a credit union must reverse the interest accrual at the time of restructuring. Delinquent interest in excess of three months is also capitalized as part of the loan asset but must also be credited to the *Allowance for Loan Losses*, thereby reducing the amount of provision (bad debt expense) necessary for the period.

Continuing the previous example, the following entry would be made for the first month following restructuring of the loan:

Dr. – Cash	\$260	
Cr. – Loans		\$166.25
Cr. - Income from Loans		93.75

Legal Fees and Other Direct Costs of Restructuring

Legal fees and other direct costs, including direct loan origination costs, incurred by the credit union in the process of restructuring should be recognized as expense in the period incurred.

NET ORIGINATION FEES AND COSTS

This section sets forth the regulatory accounting requirements for Federal credit unions in accounting for nonrefundable fees and costs associated with originating and acquiring loans. Originating and acquiring loans includes: lending, committing to lend, or purchasing a loan or group of loans.

This section applies to all types of loans extended by credit unions including consumer loans, mortgage loans, commercial and agricultural loans.

Nonrefundable Loan Origination Fees And Costs

Credit unions under \$10,000,000 in total assets may opt to use the modified cash basis of accounting. These credit unions are required, at a minimum, to amortize loan origination fees on real estate loans over the life of the loan or ten years, whichever period is shorter.

Credit unions following generally accepted accounting principals (GAAP) must use the full accrual basis of accounting. These credit unions must follow the provisions detailed below, unless the difference is not material. The provisions in this section are usually material when applied to real estate and commercial loans.

Loan Origination Fees

Origination fees are nonrefundable fees charged to the borrower in connection with the originating, refinancing or restructuring of a loan. Examples include points, management, arrangement, placement, application, underwriting, and other fees related to a lending transaction. Points charged to sellers shall be considered origination fees.

Direct loan origination costs include the following:

- a) Incremental direct costs incurred in transactions with third parties, and
- b) Certain costs relating to specific activities performed by the lender for that particular loan. The specific activities are:
 - 1) Evaluating the applicant's financial condition;
 - 2) Evaluating and recording guarantees, collateral and security arrangements;
 - 3) Negotiating loan terms;
 - 4) Preparing and processing loan documents; and
 - 5) Closing the transaction.

These costs should include only that portion of the employee's total compensation and payroll related fringe benefits for the time spent on a particular loan and other costs related to those activities on a particular loan. All other lending related costs should be expensed as incurred. Administration costs such as rent, depreciation, etc., are considered indirect costs and should be expensed as incurred. Also, direct costs do not include transactions with third parties billed directly to the applicant.

Loan origination fees should be deferred and recognized over the life of the loan as an adjustment of yield. Likewise, direct loan origination costs should be deferred and recognized over the life of the loan as a reduction in yield. The fees and costs should be offset against each other and only the net amount should be deferred and amortized. The

netting of fees and costs should be applied on an individual loan basis. The net amount should be deferred and amortized using the interest method. The objective of the interest method is to arrive at periodic interest income at a constant effective yield on the net investment (carrying value). The difference between the periodic interest income so determined and the stated interest on the outstanding principal balance is the amount of periodic amortization.

Loan origination fees charged a member and the related direct loan origination costs incurred for loans are offset with the net amount deferred and recognized over the life of the loan as an adjustment of yield using the interest method. The netting of fees and costs are applied on an individual loan basis although aggregation of similar loans is permissible under certain conditions. The practice of recognizing loan origination fees as income in the period earned/received and expensing related costs when incurred or in the period the loan is granted is no longer acceptable. The objective of the interest method is to arrive at periodic interest income at a constant effective yield on the net investment (carrying value).

Examples of the types of loan origination costs a federal credit union defers include costs related to evaluating the prospective borrower's financial condition, evaluating and recording guarantees, collateral and other such arrangements, negotiating loan terms, preparing and processing loan documents and closing the transaction. The federal credit union may only defer the portion of employee compensation and fringe benefits directly related to time spent on a specific loan as well as other costs incurred in connection with the loan.

All other lending related costs are charged to expense as incurred. This includes:

- Advertising costs, soliciting potential borrowers;
- Servicing existing loans;
- Activities related to establishing and monitoring credit policies;
- Supervision and administration;
- Employees' compensation and fringe benefits related to those activities;

- Unsuccessful loan origination efforts;
- Idle time; and
- Rent, depreciation, and all other occupancy and equipment costs.

Amounts of loan origination, commitment and other fees and costs recognized as an adjustment of yield are reported as part of interest income. The unamortized balance of loan origination, commitment and other fees and costs recognized as an adjustment of yield are reported on the federal credit union's balance sheet as part of the related loan balance.

Commitment Fees

Generally, fees received for a commitment to originate or purchase a loan or a group of loans are offset with direct loan origination costs to make a commitment and deferred. If the commitment is exercised, the net fees are recognized over the life of the loan as an adjustment of yield or, if the commitment expires unexercised, recognized in income upon expiration of the commitment. If the likelihood the commitment will be exercised is remote, the commitment fee is recognized over the commitment period on a straight-line basis as service fee income. 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.

Credit Card Fees

If material, fees periodically charged to cardholders must be deferred and recognized on a straight-line basis over the period the fee entitles the cardholder (member) to use the card.

Demand Loans

For a loan that is payable on demand, any net fees or costs may be recognized as an adjustment of yield on a straight-line basis over a period that is consistent with (1) the understanding between the borrower and lender or (2) if no understanding exists, the lender's estimate of the time period the loan will remain outstanding. Any unamortized amount is recognized when the loan is paid in full.

Revolving Lines Of Credit

For revolving lines of credit and other similar loan arrangements, the net fees or costs are recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming the borrowings are outstanding for the maximum term provided in the loan contract. If the borrower pays down the borrowings and cannot borrow again under the contract, any unamortized net fees or costs is recognized in income when paid. The interest method is applied to recognize net unamortized fees or costs when the loan agreement provides a schedule for payment and no additional borrowings are provided for under the agreement.

Purchase Of A Loan Or Group Of Loans

The initial investment in a purchased loan or group of loans includes the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loans principal amount at the date of purchase. This difference is recognized as an adjustment of yield over the life of the loan. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans are charged to expense as incurred.

The purchaser may allocate the initial investment to the individual loans or may account for the initial investment in the aggregate. The cash flows provided by the underlying loan contracts is used to apply the interest method. If prepayments are not anticipated and prepayments occur or a portion of the purchased loans are sold, a proportionate amount of the related deferred fees and purchase premium or discount is recognized in income so the effective interest rate on the remaining portion of loans continues unchanged.

Aggregation Of Similar Loans

If the federal credit union holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the federal credit union may use estimated principal repayments to calculate the constant effective yield used in the interest method.

If the federal credit union anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the federal credit union calculates the effective yield reflecting the actual payments to date and anticipated future payments. The net investment in the loans is adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans is then adjusted to the new balance with a corresponding charge or credit to interest income.

Federal credit unions that anticipate prepayments must disclose the policy and significant assumptions underlying the prepayment estimates. The practice of recognizing net fees over the estimated average life of a group of loans is no longer acceptable.

Definitions

Commitment Fees. Fees charged for entering into an agreement that obligates the Federal credit union to make or acquire a loan or satisfy an obligation of the other party under a specified condition. Commitment fees include fees for letters of credit and obligations to purchase a loan or group of loans and pass-through certificates.

Credit Card Fees. The periodic uniform fees that entitle cardholders to use credit cards including fees received in similar arrangements, such as charge card and cash card fees.

Incremental Direct Costs. Costs to originate a loan that (1) result directly from and are essential to the lending transaction and (2) would not have been incurred by the lender had the lending transaction not occurred.

Lending Activities. Lending, committing to lend, refinancing or restructuring loans, arranging standby letters of credit, syndication and participation fees to the extent they are associated with the portion of the loan retained by the lender.

Origination Fees. Fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan including points,

management, arrangement, placement, application, underwriting and also syndication and participation fees to the extent they are associated with the portion of the loan retained by the lender.

Accounting Entries, Loans And The Interest Method

Entries in the Journal and Cash Record

Net fees (costs) and their subsequent amortization should be recorded in the miscellaneous columns of the Journal and Cash Record. The unamortized balance of the net fees (costs) should be reported as part of the loan balance to which it relates. The periodic amortization should be reported on the income statement as interest income.

Illustrative Entries

Assume that a \$75,000 real estate loan is made 1/01/X1 at 10% interest. The loan is to be paid back in 15 annual installments. The credit union charges points of 3%. Direct costs were \$250.

Step 1-Determine the carrying amount of the loan:

Principal Balance of Loan	\$75,000
Less: Fees Charged	(2,250)
Plus Direct Costs	250
Carrying Amount	<u>\$73,000</u>

Step 2-Determine the unamortized net fees:

Fees Charged	\$2,250
Less: Direct Costs	(250)
Unamortized Net Fees	<u>\$2,000</u>

Step 3-Determine the yearly payment on the amount of the loan. (**Note:** A pocket calculator with present value/annuity capability can be used to determine the yearly value payment). In this case, the yearly payment is \$9,861.

Step 4-Determine the constant effective yield on the carrying amount, \$73,000. (**Note:** Again this can be done using a pocket calculator with present value capability). In this example, the constant effective

yield based on the carrying amount is 10.4782 percent.

Step 5-Determine the amount of periodic amortization.

Year 1

- Stated interest based on the outstanding principal balance = \$75,000, (\$75,000 x 10%).
- Interest income based on the carrying amount and the constant effective yield = \$7,649, (\$73,000 x .104782).
- Amount of amortization for year 1 = \$149, (\$7,649 - \$7,500).
- Total interest income for year 1 = \$7,649, (\$7,500 + \$149). (\$73,000 x .104782).
- Outstanding principal balance at the end of year 1 = \$72,639, (\$75,000 - \$9,861 + \$7,500).
- Carrying amount at the end of year 1 = \$70,788, (\$72,639 - \$2,000 + \$149).
- Net unamortized fees (costs) would be \$1,851, (\$2,000 - \$149).

Year 2

- Stated interest based on the outstanding principal balance = \$7,264, (\$72,639 x 10%).
- Interest income based on the carrying amount and constant effective yield = \$7,417, (\$70,788 x .104782).
- Amount of amortization for year 2 = \$153, (\$7,417 - \$7,264).
- Total interest income for year 2 = \$7,417, (\$7,264 + \$153).
- Outstanding Principal balance at the end of year 2 = \$70,042, (\$72,639 - \$9,861 + \$7,264).

- Carrying amount at the end of year 2 = \$68,344, (\$70,042 - \$1,851 + \$153).
- Net unamortized fees (costs) would be \$1,698, (\$1,851 - \$153).

Each succeeding year's computations would be calculated exactly the same as years 1 and 2. Should the borrower make a full repayment of the outstanding principal balance, any net unamortized fees (costs) would be taken directly into interest income.

a) To record the net origination fees (costs) per the above example.

Dr. - Cash	\$2,000
Cr. - Net Origination Fees (Costs)-Real Estate Loans Over 12 years	\$2,000

b) To record the amortization of the net origination fees (costs) when the first scheduled payment is made.

Dr. - Net Origination Fees (Costs)-Real Estate Loans Over 12 years	\$149.00
Cr. - Interest on Real Estate Loans	\$149.00

c) To record the amortization of the net origination fees (costs) when the second scheduled payment is made.

Dr. - Real Estate Loans Over 12 Years-Net Origination Fees (Costs)	\$153.00
Cr. - Interest on Real Estate Loans	\$153.00

d) To record the transaction as it pertains to the net unamortized fees (costs) should the borrower make a full prepayment when the third scheduled payment is due.

Dr. - Real Estate Loans Over 12 Years-Net Origination Fees (Costs)	\$1,698.00
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Cr. - Interest on Real Estate Loans	\$1,698.00
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Note: When the stated rate of interest changes during the term of the loan the interest method is applied as follows:

1) Should the stated interest rate increase during the term of the loan so that the interest accrued under the interest method in early periods would exceed interest at the stated rate, interest income shall not be recognized to the extent that the net investment in the loan would increase to an amount greater than the outstanding balance of the loan. In such a case, the amortization of the net fees calculated by subtracting the stated interest from the interest income based on the net investment would exceed the total unamortized fees. Therefore, the interest income is limited to the stated interest plus the unamortized net fees (costs).

2) Should the stated rate decrease during the term of the loan, the stated interest calculated early in the term of the loan would exceed interest income based on the net investment. In such a case the excess is deferred and added to the unamortized net fees thereby increasing the net investment in the loan.

3) If the loan's stated rate varies based on an independent index or rate, the calculation of the constant effective yield shall be based either on the rate in effect at the inception of the loan or on the factor as it changes over the life of the loan. If the constant effective yield is based on the rate in effect at the loan's inception, then the amortization of the net fees (costs) would be the same as if the rate had not changed. Therefore, the interest income equals the stated interest plus the amortization of the net fees (costs) on the terms of the loan at inception.

If the constant effective yield is based on the factor as it changes over the life of the loan, then a new constant effective rate would be computed when the rate changes.

Problems also can be encountered when the scheduled payment and/or payment dates are not met. Therefore, it is essential in such cases that professional assistance be consulted and that the

software necessary to amortize the net fees (costs) be obtained.

If a credit union has a large number of similar loans for which prepayments are probable and the timing and the prepayments anticipated, the effective yield should be recalculated to reflect actual payments to date and anticipated future payments. The net investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the new balance with a corresponding charge or credit to interest income. Credit unions that anticipate prepayments shall disclose that policy and the significant assumptions underlying the prepayment estimates. Detailed examples are not provided due to the complexity of the subject matter. Professional assistance should be consulted if this procedure is being contemplated.

When a borrower refinances or restructures a loan and the terms are at least as favorable to the lender as the terms for comparable loans to other members with similar collection risks who are not refinancing or restructuring, the refinanced loan should be accounted for as a new loan. Any unamortized net fees (costs) from the original loan shall be recognized as interest income when the new loan is granted.

If the refinancing does not meet the conditions discussed in the preceding paragraph, then the net fees (costs) from the original loan shall be carried forward as a part of the net investment in the new loan.

Detailed Transactions

Debit:

- a) With the amount of direct loan costs incurred.
- b) With the amount of periodic amortization of the net fees.

Credit:

and amount of the prepayments can be reasonably estimated, the credit union may consider estimates of future principal payments in the calculation of the constant effective yield. If this approach is taken and a difference arises between the prepayments received

a) With the amount of loan origination fees received.

b) With the amount of periodic amortization of the net costs.

ALLOWANCE FOR LOAN LOSSES AND LEASE LOSSES

The allowance for loan and lease losses (ALLL) is an accounting estimate of credit union losses inherent in a credit union's portfolio that have been incurred at the Statement of Financial Condition date. The objective of the ALL ALLL is to measure loans at their collectible amounts. The balance of this account is treated on the Statements of Financial Condition as a deduction from the total carrying value of loans and loan derived assets to reflect these assets at their fair value. Thus, the ALL ALLL results in a fair presentation of the financial statements in conformity with generally accepted accounting principles (GAAP) and meets regulatory requirements for full and fair disclosure.

Each credit union's method of estimating its ALL ALLL is dependent on many factors, including the credit union's size, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and data processing systems.

Accordingly, there are a variety of methods that may be used. GAAP sometimes limits the methods that may be used to evaluate the adequacy of the ALL. For example, credit unions should use the expected future cash flows discounted at the loan's effective interest rate for certain complex loans (e.g., commercial loans).

For credit unions with less than \$10 million in assets, the calculation to determine the adequacy of the ALLL as outlined in this manual remains consistent with GAAP. For other credit unions, management is advised to consult the applicable GAAP

pronouncements and/or consult their independent accountant for additional guidance.

Policy. Federal credit unions must determine an adequate and reasonable ALL. The ALL should be sufficient to cover estimated losses which exist in the loan portfolio at the financial statement date. Thereby, the ALL results in the fair presentation of financial statements in accordance with GAAP, and meets the requirements for full and fair disclosure. Credit unions must realize that under-funding the ALL, as well as over-funding the ALL, does not result in the fair presentation of financial statements in accordance with GAAP.

Boards of directors of federally-insured credit unions are responsible for ensuring that their credit unions have controls in place to consistently determine the ALLL in accordance with the credit union's stated policies and procedures, GAAP, and ALLL supervisory guidance. To fulfill this responsibility, boards of directors instruct management to develop and maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provisions for loan losses. Management should create and implement suitable policies and procedures to communicate the ALLL process internally to all applicable personnel. Regardless of who develops and implements these policies, procedures, and the underlying controls, the board of directors should assure themselves that the policies specifically address the credit union's unique goals, systems, risk profile, personnel, and other resources before approving them. Additionally, by creating an environment that encourages personnel to follow these policies and procedures, management improves procedural discipline and compliance.

The determination of the amounts of the ALLL and provisions for loan and lease losses should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the reporting date. The amounts to be reported each period for the provision for loan and lease losses and the ALLL should be reviewed and approved by the board of directors. To ensure the methodology remains appropriate for the credit union, the board of directors should have the

methodology periodically validated and, if appropriate, revised. Further, the supervisory or audit committee¹ should oversee and monitor the internal controls over the ALLL determination process.

The NCUA has a long-standing examination policy that calls for examiners to review a credit union's lending and loan review functions and recommend improvements, if needed. Agency guidance assists a credit union in estimating and establishing a sufficient ALLL supported by adequate documentation. Additionally, guidance requires operational and managerial standards that are appropriate for a credit union's size and the nature and scope of its activities.

For financial reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined in accordance with GAAP. GAAP requires that allowances be well documented, with clear explanations of the supporting analyses and rationale. This guidance describes but does not increase the documentation requirements already existing within GAAP. Failure to maintain, analyze, or support an adequate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound credit union practice.²

This guidance applies equally to all credit unions, regardless of the size. However, credit unions with less complex lending activities and products may find it more efficient to combine a number of procedures (e.g., information gathering, documentation, and internal approval processes) while continuing to ensure the credit union has a consistent and appropriate methodology. Thus, much of the supporting documentation required for a credit union with more complex products or portfolios may be combined into fewer supporting documents in a credit union with less complex

¹ All federal credit unions must establish a supervisory committee. If a federally insured state chartered credit union does not have either a supervisory or audit committee, the board of directors retains this responsibility.

² Failure to maintain adequate supporting documentation does not relieve a credit union of its obligation to record an appropriate ALLL.

products or portfolios. For example, simplified documentation can include spreadsheets, check lists, and other summary documents that many credit unions currently use. Illustrations B and D provide specific examples of how less complex credit unions may determine and document portions of their ALLL.

Documentation Standards. Appropriate written supporting documentation facilitates review of the ALLL process and reported amounts, builds discipline and consistency into the ALLL determination process, and improves the process for estimating loan and lease losses by helping to ensure that all relevant factors are appropriately considered in the ALLL analysis. A credit union should document the relationship between the findings of its detailed review of the loan portfolio and the amount of the ALLL and the provision for loan and lease losses reported in each period.

At a minimum, credit unions should maintain written supporting documentation for the following decisions, strategies, and processes:

1. Policies and procedures:
 - a. Over the systems and controls that maintain an appropriate ALLL, and
 - b. Over the ALLL methodology,
2. Loan grading system or process,
3. Summary or consolidation of the ALLL balance,
4. Validation of the ALLL methodology, and
5. Periodic adjustments to the ALLL process.

The following sections of this IRPS provide guidance on significant aspects of ALLL methodologies and documentation practices. Specifically, this IRPS provides documentation guidance on:

1. Application of GAAP,
2. Policies and Procedures,
3. Methodology,
4. ALLL Under FASB Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114),
5. ALLL Under FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5),
6. Consolidating the Loss Estimates, and

7. Validating the ALLL Methodology.

Application of GAAP. An ALLL recorded pursuant to GAAP is a credit union's best estimate of the probable amount of loans and lease-financing receivables that it will be unable to collect based on current information and events. A creditor should record an ALLL when the criteria for accrual of a loss contingency as set forth in GAAP have been met. Estimating the amount of an ALLL involves a high degree of management judgment and is inevitably imprecise. Accordingly, a credit union may determine that the amount of loss falls within a range. A credit union should record its best estimate within the range of loan losses.

Under GAAP, Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), provides the basic guidance for recognition of a loss contingency, such as the collectibility of loans (receivables), when it is probable that a loss has been incurred and the amount can be reasonably estimated. Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114) provides more specific guidance about the measurement and disclosure of impairment for certain types of loans.

Specifically, FAS 114 applies to loans that are identified for evaluation on an individual basis. Loans are considered impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the contractual terms of the loan agreement.

For individually impaired loans, FAS 114 provides guidance on the acceptable methods to measure impairment. Specifically, FAS 114 states that when a loan is impaired, a creditor should measure impairment based on the present value of expected future principal and interest cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of collateral, if the loan is collateral dependent. When developing the estimate of expected future cash flows for a loan, a credit union should consider all available information reflecting past events and current conditions,

including the effect of existing environmental factors. The Illustration A provides an example of a

credit union estimating a loan's impairment when the loan has been partially charged-off.

ILLUSTRATION A
**INTERACTION OF FAS 114 WITH AN ADVERSELY CLASSIFIED LOAN,
 PARTIAL CHARGE-OFF, AND THE OVERALL ALLL**

A credit union determined that a collateral dependent loan, which it identified for evaluation, was impaired. In accordance with FAS 114, the credit union established an ALLL for the amount that the recorded investment in the loan exceeded the fair value of the underlying collateral, less costs to sell.

Consistent with relevant regulatory guidance, the credit union classified as "Loss," the portion of the recorded investment deemed to be the confirmed loss, and classified the remaining recorded investment as "Substandard." For this loan, the amount classified "Loss" was less than the impairment amount (as determined under FAS 114). The credit union charged off the "Loss" portion of the loan. After the charge-off, the portion of the ALLL related to this "Substandard" loan (1) reflects an appropriate measure of impairment under FAS 114, and (2) is included in the aggregate FAS 114 ALLL for all loans that were identified for evaluation and individually considered impaired. The aggregate FAS 114 ALLL is included in the credit union's overall ALLL.

Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are *not* included in the scope of FAS 114. Such groups of loans may include, but are not limited to, credit card, residential mortgage, and consumer installment loans. FAS 5 addresses the accounting for impairment of these loans. Also, FAS 5 provides the accounting guidance for impairment of loans that are not identified for evaluation on an individual basis and loans that are individually evaluated but are not individually considered impaired.

Credit unions should ensure that they do not layer their loan loss allowances. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same probable loan loss. Layering can happen when a credit union includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional ALLL amount.

While different credit unions may use different methods, there are certain common elements that should be included in any loan loss allowance methodology. Generally, a credit union's methodology should:

1. Be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
2. Consider the particular risks inherent in different kinds of lending;
3. Consider current collateral values (less costs to sell), where applicable;
4. Require that analyses, estimates, reviews and other ALLL methodology functions be performed by competent and well-trained personnel;
5. Be based on current and reliable data;
6. Be well documented with clear explanations of the supporting analyses and rationale; and
7. Include a systematic and logical method to consolidate the loss estimates and ensure the ALLL balance is recorded in accordance with GAAP.

A systematic methodology that is properly designed and implemented should result in a credit union's best estimate of the ALLL. Accordingly, credit unions should adjust their ALLL balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted ALLL balance in the general ledger.

Policies and Procedures. Credit unions use a wide range of policies, procedures, and control systems in their ALLL process. Sound policies should be appropriately tailored to the size and complexity of the credit union and its loan portfolio.

In order for a credit union's ALLL methodology to be effective, the credit union's written policies and procedures for the systems and controls that maintain an appropriate ALLL should address but not be limited to:

1. The roles and responsibilities of the credit union's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine, or review, as applicable, the ALLL to be reported in the financial statements;
2. The credit union's accounting policies for loans and loan losses, including the policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable;
3. The description of the credit union's systematic methodology, which should be consistent with the credit union's accounting policies for determining its ALLL;³ and
4. The system of internal controls used to ensure that the ALLL process is maintained in accordance with GAAP and supervisory guidance.

An internal control system for the ALLL estimation process should:

- (1) Include measures to ensure the reliability and integrity of information and compliance with laws,

³ Further explanation is presented in the Methodology section that appears below.

(2) regulations, and internal policies and procedures;

(3) Reasonably ensure that the credit union's financial statements (including regulatory reports) are prepared in accordance with GAAP and ALLL supervisory guidance; and

(4) Include a well-defined loan review process containing:

(a) An effective loan grading system that is consistently applied, identifies differing risk characteristics and loan quality problems accurately and in a timely manner, and prompts appropriate administrative actions;

(b) Sufficient internal controls to ensure that all relevant loan review information is appropriately considered in estimating losses. This includes maintaining appropriate reports, details of reviews performed, and identification of personnel involved; and

(c) Clear formal communication and coordination between a credit union's credit administration function, financial reporting group, management, board of directors, and others who are involved in the ALLL determination process or review process, as applicable (e.g., written policies and procedures, management reports, audit programs, and committee minutes).

Methodology. An ALLL methodology is a system that a credit union designs and implements to reasonably estimate loan and lease losses as of the financial statement date. It is critical that ALLL methodologies incorporate management's current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process.

A credit union's ALLL methodology is influenced by credit union-specific factors, such as a credit union's size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and management information systems. However, there are certain common elements a credit union should incorporate in its ALLL methodology. A summary of common elements was provided in Application of GAAP section of this IRPS.

Documentation of ALLL Methodology in Written Policies and Procedures. A credit union's written policies and procedures should describe the primary elements of the credit union's ALLL methodology, including portfolio segmentation and impairment measurement. In order for a credit union's ALLL methodology to be effective, the credit union's written policies and procedures should describe the methodology:

- (1) For segmenting the portfolio:
 - (a) How the segmentation process is performed (i.e., by loan type, industry, risk rates, etc.),
 - (b) When a loan grading system is used to segment the portfolio:
 - (i) The definitions of each loan grade,
 - (ii) A reconciliation of the internal loan grades to supervisory loan grades, and
 - (iii) The delineation of responsibilities for the loan grading system.
- (2) For determining and measuring impairment under FAS 114:
 - (a) The methods used to identify loans to be analyzed individually;
 - (b) For individually reviewed loans that are impaired, how the amount of any impairment is determined and measured, including:
 - (i) Procedures describing the impairment measurement techniques available and
 - (ii) Steps performed to determine which technique is most appropriate in a given situation.
 - (c) The methods used to determine whether and how loans individually evaluated under FAS 114, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under FAS 5.
- (3) For determining and measuring impairment under FAS 5:

- (a) How loans with similar characteristics are grouped to be evaluated for loan collectibility (such as loan type, past-due status, and risk);
- (b) How loss rates are determined (e.g., historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience; and
- (c) Descriptions of qualitative factors (e.g., industry, geographical, economic and political factors) that may affect loss rates or other loss measurements.

The supporting documents for the ALLL may be integrated in a credit union's credit files, loan review reports or worksheets, board of directors' and committee meeting minutes, computer reports, or other appropriate documents and files.

ALLL Under FAS 114. A credit union's ALLL methodology related to FAS 114 loans begins with the use of its normal loan review procedures to identify whether a loan is impaired as defined by the accounting standard. Credit unions should document:

- (1) The method and process for identifying loans to be evaluated under FAS 114 and
- (2) The analysis that resulted in an impairment decision for each loan and the determination of the impairment measurement method to be used (i.e., present value of expected future cash flows, fair value of collateral less costs to sell, or the loan's observable market price).

Once a credit union has determined which of the three available measurement methods to use for an impaired loan under FAS 114, it should maintain supporting documentation as follows:

- (1) When using the present value of expected future cash flows method:
 - (a) The amount and timing of cash flows,
 - (b) The effective interest rate used to discount the cash flows, and

(c) The basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions.

(2) When using the fair value of collateral method:

(a) How fair value was determined, including the use of appraisals, valuation assumptions, and calculations,

(b) The supporting rationale for adjustments to appraised values, if any,

(c) The determination of costs to sell, if applicable, and

(d) Appraisal quality, and the expertise and independence of the appraiser.

(3) When using the observable market price of a loan method:

(a) The amount, source, and date of the observable market price.

Illustration B describes a practice used by a small credit union to document its FAS 114 measurement of impairment using a comprehensive worksheet. Q&A #1 and #2 in the examples presented at the end of this section provide examples of applying and

documenting impairment measurement methods under FAS 114.

Some loans that are evaluated individually for impairment under FAS 114 may be fully collateralized and therefore require no ALLL. Q&A #3 in the examples presented at the end of this section presents an example of a credit union whose loan portfolio includes fully collateralized loans and describes the documentation maintained by that credit union to support its conclusion that no ALLL was needed for those loans.

ALLL Under FAS 5. Segmenting the Portfolio.

For loans evaluated on a group basis under FAS 5, management should segment the loan portfolio by identifying risk characteristics that are common to groups of loans. Credit unions typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. **Smaller credit unions that are involved in less complex activities often segment the portfolio into broad loan categories. This method of segmenting the portfolio is likely to be appropriate only in small credit unions offering a narrow range of loan products.** Larger credit unions typically offer a more diverse and complex mix of loan products. Such credit unions may start by segmenting the portfolio into major loan types but

ILLUSTRATION B

DOCUMENTING AN ALLL UNDER FAS 114

Comprehensive worksheet for the impairment measurement process

A small credit union uses a comprehensive worksheet for each loan being reviewed individually under FAS 114. Each worksheet includes a description of why the loan was selected for individual review, the impairment measurement technique used, the measurement calculation, a comparison to the current loan balance, and the amount of the ALLL for that loan. The rationale for the impairment measurement technique used (e.g., present value of expected future cash flows, observable market price of the loan, fair value of the collateral) is also described on the worksheet.

typically have more detailed information available that allows them to further segregate the portfolio into product line segments based on the risk characteristics of each portfolio segment. Regardless of the segmentation method used, a credit union should maintain documentation to support its conclusion that the loans in each segment have similar attributes or characteristics.

As economic and other business conditions change, credit unions often modify their business strategies, which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses. Illustration C presents an example in which a credit union refined its segmentation method to more effectively consider risk factors and maintains documentation to support

this change.

Credit unions use a variety of documents to support the segmentation of their portfolios.

Some of these documents include:

- Loan trial balances by categories and types of loans,
- Management reports about the mix of loans in the portfolio,
- Delinquency and nonaccrual reports, and
- A summary presentation of the results of an internal or external loan grading review.

ILLUSTRATION C

DOCUMENTING SEGMENTING PRACTICES

Documenting a refinement in a segmentation method

A credit union with a significant portfolio of consumer loans performed a review of its ALLL methodology. The credit union had determined its ALLL based upon historical loss rates in the overall consumer portfolio. The ALLL methodology was validated by comparing actual loss rates (charge-offs) for the past two years to the estimated loss rates. During this process, the credit union decided to evaluate loss rates on an individual product basis (e.g., auto loans, unsecured loans, or home equity loans). This analysis disclosed significant differences in the loss rates on different products. With this additional information, the methodology was amended in the current period to segment the portfolio by product, resulting in a better estimation of the loan losses associated with the portfolio. To support this change in segmentation practice, the credit review committee records contain the analysis that was used as a basis for the change and the written report describing the need for the change.

Reports generated to assess the profitability of a loan product line may be useful in identifying areas in which to further segment the portfolio.

Estimating Loss on Groups of Loans

Based on the segmentation of the portfolio, a credit union should estimate the FAS 5 portion of the

ALLL. For those segments that require an ALLL,⁴ the credit union should estimate the loan and lease losses, on at least a quarterly basis, based upon its ongoing loan review process and analysis of loan performance. The credit union should follow a systematic and consistently applied approach to select the most appropriate loss measurement methods and support its conclusions and rationale with written

⁴ An example of a loan segment that does not generally require an ALLL is loans that are fully secured by deposits maintained at the lending credit union.

documentation. Regardless of the method used to measure losses, a credit union should demonstrate and document that the loss measurement methods used to estimate the ALLL for each segment are determined in accordance with GAAP as of the financial statement date.⁵

One method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect historical loan loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a defined period of time. If a credit union does not have loss experience of its own, it may be appropriate to reference the loss experience of other credit unions, provided that the credit union demonstrates that the attributes of the loans in its portfolio segment are similar to those of the loans included in the portfolio of the credit union providing the loss experience.⁶ Credit unions should maintain supporting documentation for the technique used to develop their loss rates, including the period of time over which the losses were incurred. If a range of loss is determined, credit unions should maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of loan losses. An example of how a small credit union performs a comprehensive historical loss analysis is provided as the first item in Illustration D.

Before employing a loss estimation model, a credit union should evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. In order to demonstrate consistency with GAAP, credit unions that use loss estimation models typically document the evaluation, the conclusions regarding the appropriateness of estimating loan losses with a model or other loss estimation tool, and the support for adjustments to the model or its results. In developing loss measurements, credit unions should consider the impact of current environmental factors

⁵ Refer to paragraph 8(b) of FAS 5. Also, the AICPA is currently developing a Statement of Position that will provide more specific guidance on accounting for loan losses.

⁶ Refer to paragraph 23 of FAS 5.

and then document which factors were used in the analysis and how those factors affect the loss measurements. Factors that should be considered in developing loss measurements include the following:⁷

- (1) Levels of and trends in delinquencies and impaired loans;
- (2) Levels of and trends in charge-offs and recoveries;
- (3) Trends in volume and terms of loans;
- (4) Effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practices;
- (5) Experience, ability, and depth of lending management and other relevant staff;
- (6) National and local economic trends and conditions;
- (7) Industry conditions; and
- (8) Effects of changes in credit concentrations.

For any adjustment of loss measurements for environmental factors, the credit union should maintain sufficient, objective evidence to support the amount of the adjustment and to explain why the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss measurements.

The second item in Illustration D provides an example of how a credit union adjusts its business real estate historical loss rates for changes in local economic conditions. Q&A #4 in the examples presented at the end of this section provides an example of maintaining supporting documentation for adjustments to portfolio segment loss rates for an environmental factor related to an economic downturn in the borrower's primary industry. Q&A #5 in the examples presented at the end of this section describes one credit union's process for determining and documenting an ALLL for loans that are not individually impaired but have characteristics indicating there are loan losses on a group basis.

⁷ Refer to paragraph 6.08 in the AICPA Audit Guide.

ILLUSTRATION D DOCUMENTING THE SETTING LOSS RATES

Comprehensive loss analysis in a small credit union

A small credit union determines its loss rates based on loss rates over a three-year historical period. The analysis is conducted by type of loan and is further segmented by originating branch office. The analysis considers charge-offs and recoveries in determining the loss rate. The credit union also considers the loss rates for each loan grade and compares them to historical losses on similarly rated loans in arriving at the historical loss factor. The credit union maintains supporting documentation for its loss factor analysis, including historical losses by type of loan, originating branch office, and loan grade for the three-year period.

Adjustment of loss rates for changes in local economic conditions

A credit union develops a factor to adjust loss rates for its assessment of the impact of changes in the local economy. For example, when analyzing the loss rate on business real estate loans, the assessment identifies changes in recent commercial building occupancy rates. The credit union generally finds the occupancy statistics to be a good indicator of probable losses on these types of loans. The credit union maintains documentation that summarizes the relationship between current occupancy rates and its loss experience.

Consolidating The Loss Estimates. To verify that ALLL balances are presented fairly in accordance with GAAP and are auditable, management should prepare a document that summarizes the amount to be reported in the financial statements for the ALLL. The board of directors should review and approve this summary.

Common elements in such summaries include:

- (1) An estimate of the probable loss or range of loss incurred for each category evaluated (e.g.,
- (2) Individually evaluated impaired loans, homogeneous pools, and other groups of loans that are collectively evaluated for impairment);

(3) The aggregate probable loss estimated using the credit union's methodology;

(4) A summary of the current ALLL balance;

(5) The amount, if any, by which the ALLL is to be adjusted;⁸ and

(6) Depending on the level of detail that supports the ALLL analysis, detailed sub-schedules of loss estimates that reconcile to the summary schedule.

Illustration E describes how a credit union documents its estimated ALLL by adding comprehensive explanations to its summary schedule.

⁸ Subsequent to adjustments, there should be no material differences between the consolidated loss estimate, as determined by the methodology, and the final ALLL balance reported in the financial statements.

ILLUSTRATION E

SUMMARIZING LOSS ESTIMATES

Descriptive comments added to the consolidated ALLL summary schedule

To simplify the supporting documentation process and to eliminate redundancy, a credit union adds detailed supporting information to its summary schedule. For example, this credit union's board of directors receives, within the body of the ALLL summary schedule, a brief description of the credit union's policy for selecting loans for evaluation under FAS 114. Additionally, the credit union identifies which FAS 114 impairment measurement method was used for each individually reviewed impaired loan. Other items on the schedule include brief descriptions of loss factors for each segment of the loan portfolio, the basis for adjustments to loss rates, and explanations of changes in ALLL amounts from period to period, including cross-references to more detailed supporting documents.

Generally, a credit union's review and approval process for the ALLL relies upon the data provided in these consolidated summaries. There may be instances in which individuals or committees that review the ALLL methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of loan losses. These changes may be due to information not known at the time of the initial loss estimate (e.g., information that surfaces after determining and adjusting, as necessary, historical loss rates, or a recent decline in the marketability of property after conducting a FAS 114 valuation based upon the fair value of collateral). It is important that these adjustments are consistent with GAAP and are reviewed and approved by appropriate personnel. Additionally, the summary should provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, management should document the nature of any adjustments and the underlying rationale for making the changes. This documentation should be provided to those making the final determination of the ALLL amount. Q&A #6 in the examples presented at the end of this section addresses the documentation of the final amount of the ALLL.

Validating the ALLL Methodology. A credit union's ALLL methodology is considered valid when it accurately estimates the amount of loss contained in the portfolio. Thus, the credit union's methodology should include procedures that adjust

loss estimation methods to reduce differences between estimated losses and actual subsequent charge-offs, as necessary.

To verify that the ALLL methodology is valid and conforms to GAAP and supervisory guidance, a credit union's directors should establish internal control policies, appropriate for the size of the credit union and the type and complexity of its loan products. These policies should include procedures for a review, by a party who is independent of the ALLL estimation process, of the ALLL methodology and its application in order to confirm its effectiveness.

In practice, credit unions employ numerous procedures when validating the reasonableness of their ALLL methodology and determining whether there may be deficiencies in their overall methodology or loan grading process. Examples are:

- (1) A review of trends in loan volume, delinquencies, restructurings, and concentrations.
- (2) A review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries.
- (3) A review by a party that is independent of the ALLL estimation process. This often involves the

(4) independent party reviewing, on a test basis, source documents and underlying assumptions to determine that the established methodology develops reasonable loss estimates.

(5) An evaluation of the appraisal process of the underlying collateral. This may be accomplished by periodically comparing the appraised value to the actual sales price on selected properties sold.

See more guidance concerning validation of the ALLL methodology in the *Supervisory Committee Guide*, Chapter 11, Allowance for Loan and Lease Losses.

Supporting Documentation for the Validation Process. Management usually supports the validation process with the workpapers from the ALLL review function. Additional documentation often includes the summary findings of the independent reviewer. The credit union's board of directors, or its designee, reviews the findings and acknowledges its review in its meeting minutes. If the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes should be maintained.

GAAP requires recognition of an estimated loss if both of the following conditions are met:

- 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. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss. The Financial Accounting Standards Board (FASB) recognized that the application of the term "probable" in practice requires judgment, and to clarify its intent the FASB reiterated that probable does not mean virtually certain. Probable is a higher level of likelihood than "more likely than not."
- The amount of the loss can be reasonably estimated. Whether the amount of loss can be reasonably estimated will normally depend on, among other things, the experience of the credit union, information about the ability of

individual members to pay, and appraisal of the loans in light of the current economic environment. In the case of a credit union that has no experience in this area, reference to the experience of other financial institutions in the same business may be appropriate. In all cases, GAAP requires a reasonable basis for quantifying the amount of loss and that estimated losses should be accrued by a charge to income if the above conditions are met.

Management's Responsibility. Credit union 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 problems loans, leases, and commitments; and current and anticipated economic conditions that may affect the borrower's ability to pay. Credit unions should review the adequacy of the ALL at least quarterly, or at the end of each regular share account dividend period, or more often as required. It is also critical that credit union management practice the timely charge-off of "loss loans". Charge-off policies must clearly identify charge-off criteria. For sound internal control, monthly board minutes must reflect the discussion and recognition of identified loan losses.

Adequacy of the ALL. There is no one method that is guaranteed consistently, in all instances and under every circumstance, to ensure that the ALL is adequate and in compliance with GAAP. There are various methods by which management can estimate it's ALL and that no single method is preferable. However, GAAP states that the method used should be consistent, comprehensive, logical, and relevant to the institution's particular circumstances, and that the calculation should be comprehensive, taking into account the risks inherent in the various types of lending.

Examples of categories often used include:

- a) A specific portion to cover specifically identified doubtful or troubled loans.

- b) A specific portion for pools of classified loans.
- c) A specific portion for pools of homogeneous loans.

NCUA allows a range of loss or an estimated loss percentage associated with each component for noncomplex type loans. The percentage is then applied to the individual components. Management should ensure that loans are not excluded from a component or segment. The estimated losses associated with the individual components are accumulated to assist in the ALL evaluation. Analytical methods alone generally do not produce acceptable results; therefore, management may wish to perform detailed loan reviews.

In evaluating the amount or range of loss associated with an individual loan, management should review the expected sources of repayment and the apparent ability of the borrower to generate such repayment.

Management Considerations. Loan underwriting is strongest, and the need for a substantial ALL least likely, when management:

- a) Understands the lending environment and appreciates the value of credit strategy and credit risk including: collateral risk, concentration risk, management risk, operations risk, and fraud or insider abuse risk.
- b) Establishes a good system of lending policies, procedures and internal controls to guide loan origination and disbursement: credit initiation, credit investigation, loan approval, documentation of credit, perfection of collateral interest, disbursement of loan proceeds, credit monitoring, collection, and internal loan review.

Examination Testing. Credit union management is responsible for determining an adequate ALL and adopting a reasonable methodology in accordance with GAAP and regulatory requirements. NCUA is responsible for testing the adequacy of the ALL credit union management has so determined, during, and within the limitations of, the annual examination. NCUA examiners will check the adequacy of the

ALL by using the following test as a guideline. While this method may produce results that approximate an acceptable ALL under GAAP, it tends to be conservative, and care must be taken in interpreting the results.

- 1) Review each delinquent or non-performing loan and selected large loans and determine the amounts that are losses or doubtful of collection (Adjustment Method). Refinancing and extension agreements without an adequate payment history would be considered non-performing. Add the anticipated loss amount for each loan.
- 2) Compute the credit union's 5-year average loss ratio (Experience Method). Determine whether this is a reasonable ratio to apply to the balance of the loan portfolio in light of current economic conditions and unusually high or low charge-offs in prior periods. Multiply this ratio by total loans outstanding less loan balances for loans which have been individually classified and reserved for per step (1). For those credit unions which maintain sufficient detail, computing a loss ratio for each loan category (i.e., auto, real estate, business, etc.) would be appropriate.

Note: Examiners have been instructed to use their judgment. The analysis and estimate of probable losses in the ALLL, especially in step (2), should be tempered by economic realities, i.e., it may be appropriate to shorten the historical time period during periods of significant economic expansion or contraction to more accurately reflect loss expedience in the current economic climate. The loss ratio may be adjusted upward or downward based on the asset quality cycle (i.e., stable, declining or improving).

- 3) The sum of steps (1) and (2) above are compared to the existing ALL account balance and the balance adjusted if it is materially different and there are no extenuating circumstances.

Definition of Contingency. An existing condition, situation, or set of circumstances involving uncertainty as to possible gain (a gain contingency) or loss (a loss contingency) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.

Illustrative Entries:

The following illustrates common general ledger transaction involving the ALLL :

- a) To establish or increase the credit balance, and to eliminate/reduce a debit balance, in this account:

Dr. - Provision for Loan	
Losses	\$1,000.00
Cr. - Allowance for Loan	
Losses	\$1,000.00

- b) To decrease the credit balance in this account:

Dr. - Allowance for Loan	
Losses	\$400.00
Cr. - Provision for Loan	
Losses	\$400.00

- c) To record the charge-off of loans when authorized by the board of directors:

Dr. - Allowance for Loan	
Losses	\$350.00
Cr. - Loans	\$350.00

- d) To record recoveries realized on loans charged-off:

Dr. - Cash	\$30.00
Cr. - Allowance for Loan Losses	\$30.00

- e) When recovery is made on a loan previously charged-off which has been placed in the hands of an outside collection agency and the agency withholds its fee from the amount remitted to the credit union (e.g., paid by borrower, \$17.40; fee withheld, 20 percent; remitted \$13.92):

Dr. - Cash	\$13.92
Dr. - Collection Expense	3.48
Cr. - Allowance for Loan	
Losses	\$17.40

Additional Guidance. Additional ALLL guidance can be found in the appropriate GAAP literature. If you have any problems or questions, please call the your examiner, your independent accountant, your NCUA regional office, and/or your state regulator.

ALLL QUESTIONS AND ANSWERS

Introduction

The Questions and Answers (Q&As) presented in this section are part of IRPS 02-3 serve several purposes, including (1) to illustrate the NCUA's views, as set forth in this IRPS, about the types of decisions, determinations, and processes a credit union should document with respect to its ALLL methodology and amounts; and (2) to illustrate the types of ALLL documentation and processes a credit union might prepare, retain, or use in a particular set of circumstances. The level and types of documentation described in the Q&As should be considered neither the minimum acceptable level of documentation nor an all-inclusive list. Credit unions are expected to apply the guidance in this IRPS to their individual facts, circumstances, and situations. If a credit union's fact pattern differs from the fact patterns incorporated in the following Q&As, the credit union may decide to prepare and maintain different types of documentation than did the credit unions depicted in these Q&As.

Q&A #1 - ALLL Under FAS 114 – Measuring and Documenting Impairment

Facts: Approximately one-third of Credit Union A's business loan portfolio consists of large balance, non-homogeneous loans. Due to their large individual balances, these loans meet the criteria under Credit Union A's policies and procedures for individual review for impairment under FAS 114. Upon review of the large balance loans, Credit Union A determines that certain of the loans are impaired as defined by FAS 114.

Question: For the business loans reviewed under FAS 114 that are individually impaired, how should Credit Union A measure and document the impairment on those loans? Can it use an impairment measurement method other than the methods allowed by FAS 114?

Interpretive Response: For those loans that are reviewed individually under FAS 114 and considered individually impaired, Credit Union A must use one of the methods for measuring impairment that is specified by FAS 114 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral). Accordingly, in the circumstances described above, for the loans considered individually impaired under FAS 114, it would not be appropriate for Credit Union A to choose a measurement method not prescribed by FAS 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its business loans for the past five years.

Credit Union A should maintain, as sufficient, objective evidence, written documentation to support its measurement of loan impairment under FAS 114. If Credit Union A uses the present value of expected future cash flows to measure impairment of a loan, it should document the amount and timing of cash flows, the effective interest rate used to discount the cash flows, and the basis for the determination of cash flows, including consideration of current environmental factors¹ and other information reflecting past events and current conditions. When Credit Union A uses the fair value of collateral to measure impairment, Credit Union A should document how it determined the fair value, including the use of appraisals, valuation

¹ Question #16 in Exhibit D-80A of EITF Topic D-80 and attachments indicates that environmental factors include existing industry, geographical, economic, and political factors.

assumptions and calculations, the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable, appraisal quality, and the expertise and independence of the appraiser. Similarly, Credit Union A should document the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

Q&A #2 – ALLL Under FAS 114 – Measuring Impairment for a Collateral Dependent Loan

Facts: Credit Union B has a \$10 million loan outstanding to Member X that is secured by real estate, which Credit Union B individually evaluates under FAS 114 due to the loan's size. Member X is delinquent in its loan payments under the terms of the loan agreement. Accordingly, Credit Union B determines that its loan to Member X is impaired, as defined by FAS 114. Because the loan is collateral dependent, Credit Union B measures impairment of the loan based on the fair value of the collateral. Credit Union B determines that the most recent valuation of the collateral was performed by an appraiser eighteen months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was \$12 million.

Credit Union B believes that certain of the assumptions that were used to value the collateral eighteen months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral. Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, credit review personnel at Credit Union B adjust certain of the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral.² After adjusting the collateral valuation assumptions, the credit review department determines that the current estimated fair value of the collateral, less costs to sell, is \$8 million. Given that the recorded investment in the loan is \$10 million, Credit Union B concludes that the loan is impaired by \$2 million and records an allowance for loan losses of \$2 million.

Question: What type of documentation should Credit Union B maintain to support its determination of the allowance for loan losses of \$2 million for the loan to Member X?

Interpretive Response: Credit Union B should document that it measured impairment of the loan to Member X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be \$8 million. This documentation should include the credit union's rationale and basis for the \$8 million valuation, including the revised valuation assumptions it used, the valuation calculation, and the determination of costs to sell, if applicable. Because Credit Union B arrived at the valuation of \$8 million by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from \$12 million eighteen months ago to \$8 million in the current period.³

Q&A #3 – ALLL Under FAS 114 – Fully Collateralized Loans

Facts: Credit Union C has \$500,000 in business loans that are fully collateralized by purchased business equipment. The loan agreement for each of these loans requires the borrower to provide qualifying collateral

² When reviewing collateral dependent loans, Credit Union B may often find it more appropriate to obtain an updated appraisal to estimate the effect of current market conditions on the appraised value instead of internally estimating an adjustment.

³ In accordance with the FFIEC's **Federal Register** Notice, Implementation Issues Arising from FASB No. 114, "Accounting by Creditors for Impairment of a Loan," published February 10, 1995 (60 FR 7966, February 10, 1995), impaired, collateral-dependent loans must be reported at the fair value of collateral, less costs to sell, in regulatory reports. This treatment is to be applied to all collateral-dependent loans, regardless of type of collateral.

sufficient to fully secure each loan. The member borrowers have physical control of the collateral. Credit Union C perfected its security interest in the collateral when the funds were originally distributed. On an annual basis, Credit Union C determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. Semiannually or more frequently as needed, the Credit Union C's credit administration function physically inspects the equipment. If there are any collateral deficiencies, Credit Union C notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Credit Union C has historically not incurred any material losses on these loans. Credit Union C believes these loans are fully-collateralized and therefore does not maintain any ALLL balance for these loans.

Question: What documentation does Credit Union C maintain to adequately support its determination that no allowance is needed for this group of loans?

Interpretive Response: Credit Union C's management summary of the ALLL includes documentation indicating that, in accordance with the credit union's ALLL policy, the collateral protection on these loans has been verified by the credit union, no probable loss has been incurred, and no ALLL is necessary. Documentation in Credit Union C's loan files includes the two independent market quotes obtained annually for each loan's collateral amount, the documents evidencing the perfection of the security interest in the collateral, and other relevant supporting documents. Additionally, Credit Union C's ALLL policy includes a discussion of how to determine when a loan is considered "fully collateralized" and does not require an ALLL. Credit Union C's policy requires the following factors to be considered and the credit union's findings concerning these factors to be fully documented:

1. Volatility of the market value of the collateral;
2. Recency and reliability of the appraisal or other valuation;
3. Recency of the credit union or other third party inspection of the collateral;
4. Historical losses on similar loans;
5. Confidence in the credit union's lien or security position including appropriate:
 - a. Type of security perfection (e.g., physical possession of collateral or secured filing);
 - b. Filing of security perfection (i.e., correct documents and with the appropriate officials); and
 - c. Relationship to other liens.
6. Other factors as appropriate for the loan type

Q&A #4 – ALLL Under FAS 5 – Adjusting Loss Rates

Facts: Credit Union D's field of membership (lending area) includes a metropolitan area that is financially dependent upon the profitability of a number of sponsor manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these sponsor manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices and the sponsor manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins. Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the sponsor manufacturing businesses are experiencing financial difficulties and have recently announced downsizing plans.

Although Credit Union D has yet to confirm an increase in its loss experience as a result of these events, management knows that the credit union lends to a significant number of member's for business and individual purposes whose repayment ability depends upon the long-term viability of the sponsor manufacturing businesses. Credit Union D's management has identified particular segments of its business and consumer

member bases that include member borrowers highly dependent upon sales or salary from the sponsor manufacturing businesses. Credit Union D's management performs an analysis of the affected portfolio segments to adjust its historical loss rates used to determine the ALLL. In this particular case, Credit Union D has experienced similar business and lending conditions in the past that it can compare to current conditions.

Question: How should Credit Union D document its support for the loss rate adjustments that result from considering these manufacturing firms' financial downturns?

Interpretive Response: Credit Union D should document its identification of the particular segments of its business and consumer loan portfolio for which it is probable that the sponsor manufacturing business' financial downturn has resulted in loan losses. In addition, Credit Union D should document its analysis that resulted in the adjustments to the loss rates for the affected portfolio segments. As part of its documentation, Credit Union D maintains copies of the documents supporting the analysis, including relevant newspaper articles, economic reports, and economic data, and notes from discussions with individual member borrowers.

Because in this case Credit Union D has had similar situations in the past, its supporting documentation also includes an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. As part of its effective ALLL methodology, Credit Union D creates a summary of the amount and rationale for the adjustment factor, which management presents to the audit committee and board for their review and approval prior to the issuance of the financial statements.

Q&A #5 – ALLL Under FAS 5 – Estimating Losses on Loans Individually Reviewed for Impairment but Not Considered Individually Impaired

Facts: Credit Union E has outstanding loans of \$875,000 to Member Y and \$725,000 to Member Z, both of which are paying as agreed upon in the loan documents. The credit union's ALLL policy specifies that all loans greater than \$700,000 must be individually reviewed for impairment under FAS 114. Member Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt service requirements. In contrast, recent information indicates Member Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the credit union's loan grading system. Despite its concern, management believes Member Z will resolve its problems and determines that neither loan is individually impaired as defined by FAS 114.

Credit Union E segments its loan portfolio to estimate loan losses under FAS 5. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Member Y has risk characteristics similar to the loans included in Segment 1 and the loan to Member Z has risk characteristics similar to the loans included in Segment 2.⁴

In its determination of the ALLL under FAS 5, Credit Union E includes its loans to Member Y and Member Z in the groups of loans with similar characteristics (i.e., Segment 1 for Member Y's loan and Segment 2 for Member Z's loan). Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors provides a reasonable estimate of the credit union's probable loan losses in these segments.

⁴ These groups of loans do not include any loans that have been individually reviewed for impairment under FAS 114 and determined to be impaired as defined by FAS 114.

Question: How does Credit Union E adequately support and document an ALLL under FAS 5 for these loans that were individually reviewed for impairment but are not considered individually impaired?

Interpretive Response: As part of Credit Union E's effective ALLL methodology, it documents the decision to include its loans to Member Y and Member Z in its determination of its ALLL under FAS 5. It also documents the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively. Credit Union E maintains documentation to support its method of estimating loan losses for Segment 1 and Segment 2, including the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates. The credit union also maintains copies of the economic and other reports that provided source data.

Q&A #6 - Consolidating the Loss Estimates – Documenting the Reported ALLL

Facts: Credit Union F determines its ALLL using an established systematic process. At the end of each period, the accounting department prepares a summary schedule that includes the amount of each of the components of the ALLL, as well as the total ALLL amount, for review by senior management, the Credit Committee, and, ultimately, the board of directors. Members of senior management and the Credit Committee meet to discuss the ALLL. During these discussions, they identify changes to be made to certain of the ALLL estimates. As a result of the adjustments made by senior management, the total amount of the ALLL changes. However, senior management (or its designee) does not update the ALLL summary schedule to reflect the adjustments or reasons for the adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original ALLL summary schedule that was reviewed by management and the Credit Committee, as well as a verbal explanation of the changes made by senior management and the Credit Committee when they met to discuss the loan loss allowance.

Question: Are Credit Union F's documentation practices related to the balance of its loan loss allowance appropriate?

Interpretive Response: No. A credit union must maintain supporting documentation for the loan loss allowance amount reported in its financial statements. As illustrated above, there may be instances in which ALLL reviewers identify adjustments that need to be made to the loan loss estimates. The nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the ALLL balance should be documented. Appropriate documentation of the adjustments should be provided to the board of directors (or its designee) for review of the final ALLL amount to be reported in the financial statements. For credit unions subject to external audit, this documentation should also be made available to the supervisory committee and its independent accountants. If changes frequently occur during management or committee reviews of the ALLL, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the credit union uses.

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ACCRUED INTEREST RECEIVABLE

These accounts apply to credit unions that are following the full accrual basis of accounting. The accounts may also be adopted for use by credit unions following the modified cash basis of accounting. Credit unions using these accounts should include in their accounts and financial statements interest earned during each month, or other period adopted, instead of including interest only sporadically when received in cash. The recording of income on investments under the accrual procedures set forth in "Accrued Income on Investments" is particularly recommended for credit unions with substantial investments.

ACCRUED INTEREST ON LOANS

For credit unions following the accrual basis of accounting in recording interest on loans, this account reflects the aggregate amount of accrued interest earned but not yet collected on loans outstanding. The accrued interest earned should include the applicable amount of amortization relating to net origination fees. This account also

includes accrued interest earned on notes and contracts receivable from nonmembers (resulting from the assumption of members' real estate loans or the sale of *Assets Acquired in Liquidation of Loans*) and from loans purchased from liquidating credit unions. The accrued interest earned on loans purchased from liquidating credit unions should include the applicable amount of amortization relating to the discount on loans purchased.

At the end of each month the credit union should record in this account, interest earned but not yet received on outstanding loans with an offsetting credit to the "Interest on Loans" account. The computation of interest earned may be derived through manual computations or from computer totals, if applicable.

Interest should not be accrued on loans 3 months or more delinquent. Accruals of interest on loans should be reversed when the loan is determined to be a loss or when it becomes 12 months delinquent whichever occurs first, by debiting the appropriate income account and crediting the appropriate accrued income account. Accrual of interest may

continue, however, if the credit union is receiving substantial payments and expects to receive full payment. Interest collected during the month should be credited to income and the accrual process is then repeated at the next month end. As an alternative to reversing the accrual entry on the first day of the following month, interest collected may be credited to accrued income until that account reaches zero with subsequent interest collections being credited to income.

Adjustments should be made to this account:

- When required based on a periodic verification made to determine actual accrued interest receivable on loans, or on a segment of loans for which a separate sub-control of accrued interest receivable is maintained.
- For accrued interest charged off with the approval of the board of directors, with offsetting debit to "Allowance for Loan Losses".

Entries in the Journal and Cash Record

This account should be debited each month with summary accruals of interest earned based on Journal Voucher entries made in the "Miscellaneous Debit" column. The credits to this account should consist mainly of entries made to reverse accruals. Other entries to this account should be posted from the "Miscellaneous" columns for adjustments, either debit or credit, made to this account.

Illustrative Entries

a) To record the total interest earned on loans for the month:

Dr.-Accrued Interest on Loans	\$6,500	
Cr.-Interest on Loans		\$6,500

b) To record reversal of the accrual entry on the first day of the following month:

Dr.-Interest on Loans	\$6,500	
Cr.-Accrued Interest on Loans		\$6,500

c) If the periodic inventory made to determine whether the balance of this account is equal to the actual interest earned but not collected on outstanding loans show that this account balance is overstated by \$230.00, the entry to adjust would be:

Dr.-Interest on Loans	\$230	
Cr.-Accrued Interest on Loans		\$230

Note: If this account balance is understated, the opposite entry would be made, debiting "Accrued Interest on Loans" and crediting "Interest on Loans".

Detailed Transactions

Debit:

- At the end of each month with interest earned on loans outstanding.
- With adjustments, subject to the approval of the board of directors, when the periodic inventory to verify this account exceeds the balance of this account.

Credit:

- With interest on loans collected.
- With adjustments to charge off interest accrued when loans are charged off, subject to the approval of the board of directors.
- With adjustments, subject to the approval of the board of directors, when the periodic inventory

to verify this account is less than the balance of this account.

interest is usually available on periodic reports. The amount of accrued interest for credit unions on a manual system can be determined by totaling the outstanding loan balances at each effective interest rate and multiplying these totals by the respective interest rate factors. (The figures obtained then have to be adjusted to take into consideration the length of time since the last loan payments.) The formula for this computation is:

Sample Computations

When the individual loan ledgers are maintained by electronic data processing, the amount of unpaid

$$\begin{array}{rcccl}
 \text{Total Loan Balances} & \times & \text{No. of days interest due} & \times & \text{Interest rate} & = & \text{Amount of Accrued Interest} \\
 & & 365 & & 100 & &
 \end{array}$$

As a simple example of calculating earned but uncollected interest, assume that as of June 30, a credit union has \$300,000 in loans outstanding at 9% interest and \$400,000 in loans outstanding at 12% interest. Assume further that all loans are

repaid by payroll deductions that are credited on the 15th day of each month. Application of the above formula for each interest rate is illustrated as follows.

\$300,000 Loans outstanding	X	<u>15</u> 365	X	<u>9</u> 100	=	\$1,109.59
\$400,000 Loans outstanding	X	<u>15</u> 365	X	<u>12</u> 100	=	\$1,972.50
Total accrued interest, June 15 to June 30					=	\$3,082.09

This manual estimation method would naturally be more complicated whenever the loans have various payment dates that are unevenly spread throughout the month. It is acceptable in those cases to make an estimate of the weighted average number of days since last payment for use in place of the actual number of days in the above method.

To illustrate this procedure, assume that a credit union posts several payroll deductions to loans during the month. The procedure involves totaling the number of days of unpaid interest and the number of loans from each payroll deduction and then dividing the total number of days of unpaid interest by the number of loans outstanding. This procedure is shown on the next page illustration:

Dates of Payroll Deduction Posting	No. of Days To Month-End	No. of Loans	Total No. Days of Unpaid Interest
June 2 - Salaried employees - paid monthly	28	8	224
June 12 - Office employees - paid monthly	18	32	576
June 17 - Supervisors - paid Biweekly	13	18	234
June 25 - Other employees - paid weekly	5	970	4,850
June 29 - Credit Union Employees - paid weekly	1	4	4
		1,032	5,888

The weighted average number of days since the last principle payment = $5,888/1,032 = 5.7$ days. Thus, 5.7 days would be a reasonable estimate of the weighted average number of days since last payment to be used in the above formula for computing accrued interest at month-end.

Combination of cash payments and irregular payroll deductions of various amounts could further complicate estimations of accrued interest. Most credit unions falling into this category probably use electronic data processing systems that automatically provide the necessary information. However, those credit unions on manual systems may design their own method of estimating accrued interest, provided the method results in a reasonably accurate estimate and is consistently applied.

If payroll deductions are received on the same dates every month, interest rates do not change, loan volume is relatively stable, and all loans are repaid on a monthly basis, the amount of interest accrued should not vary greatly from month to month. In many cases, it would be permissible to use the same accrued figures for a 3-month period. It will be necessary, however, to recalculate the accruals

at least quarterly and make any necessary adjustments.

Accruals of interest on loans can be reversed on the first day of the following month by debiting the appropriate income account and crediting the appropriate accrued income account. Interest collected during the month can then be credited to income and the accrual process repeated at the next month-end. As a preferable alternative to reversing the accrual entry on the first day of the following month, interest collected may be credited to accrued income until that account reaches zero with subsequent interest collections being credited to income.

ACCRUED INTEREST ON INVESTMENTS

Purchased Accrued Interest Receivable

This account is used to record the purchase of accrued interest on investments. The purchased accrued interest accumulated from the date of the last interest payment on the investment to the date of purchase of the investment. The accrued interest receivable should be recorded when the credit union records the purchase of the investment.

Refer to the "Investments" section of this manual for further explanation and illustrative entries.

Accrued Interest on Investments

For credit unions using the accrual basis of accounting to record income from investments, this account reflects the total amount of interest earned but not yet collected.

Interest on investments should be debited to this account in each accrual period (monthly, quarterly, or at the end of a regular share account dividend period) to show the actual amount earned in the period based upon the time the investments are owned or held; the offsetting credit should be to the appropriate investment income account. When the interest is received, or credited to the investment account (common trust or mutual fund investments, investments in savings and loans associations, investments in credit union shares, etc.), this account should be credited.

Interest on U. S. Government Obligations and Federal Agency Securities may be accrued on a 30-day month. Interest from other investments normally should be accrued on an actual day (365/366-day year) basis.

Where interest is accrued based on estimates (e.g., income on Common Trust or Mutual Fund Investments or shares in savings and loan associations and other credit unions), an appropriate adjustment to the accrual amounts should be made when the actual amounts are known.

Illustrative Entries

a) To accrue one month's interest on \$12,000 of 5 percent U.S. Government Obligations; semiannual interest amount of \$300.00 is divided by 6 to compute amount applicable to each month:

Dr.-Accrued Interest on Investments	\$50.00
Cr.-Interest from U.S. Government Obligations	\$50.00

b) To estimate and accrue the interest on Common Trust or Mutual Fund Investments, apply the effective rate of interest shown on the most recent advice of interest received to the average balance of the investment for the period; e.g. average investments of \$10,000 x 4.8% rate equals \$480 for a year, current accrual for 1 month - \$480 divided by 12 equals \$40.00:

Dr.-Accrued Interest on Investments	\$40.00
Cr.-Interest from Mutual Funds/Common Trust Investments	\$40.00

c) Building on entry b. above, if the advice of interest credited on the Common Trust or Mutual Fund Investments received in the ensuing month shows income credited for the preceding month as \$46.00, the following adjustment should be made:

Dr.-Available-for-Sale Securities	\$46.00
Cr.-Interest from Mutual Funds/Common Trust Investments	\$6.00
Cr.-Accrued Interest on Investments	40.00

d) Upon receipt of interest from investments:

Dr.-Cash	\$600.00
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Cr.-Accrued Interest on Investments	\$600.00
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e) To accrue interest on shares in other credit unions, use the applicable rate for the most recent dividend paid by the credit union in which shares are owned and accrue periodic interest as follows:

Dr.-Accrued Interest on Investments	\$300.00
Cr.-Interest from Shares/Deposits/Certificates of Other Credit Unions	\$300.00

Note: When the actual dividend is received, an adjustment of the accrual should be made for the difference, if any, between the estimated and actual interest.

Detailed Transactions

Debit:

- a) With interest earned applicable to the accrual period on all types of investments.
- b) With the amount of accrued interest purchased to the date of acquisition of securities when investments are made in bonds or other securities.

Credit:

- a) With interest and dividends collected or added to the investment account(s), as the transactions occur.

Refer to the “Investments” section of this manual for further information and illustrative entries relative to accounting for investment interest.

OTHER REAL ESTATE OWNED

ASSETS ACQUIRED IN LIQUIDATION OF LOANS

This account reflects the value of assets acquired by the credit union in the liquidation of loans for which the related loan obligation of the borrower has been canceled.

When the credit union takes possession of collateral and the borrower's obligation to the credit union has been canceled, (by legal requirement in some jurisdictions or by some action of the board of directors), then the fair value of the collateral should be transferred to “Assets Acquired in Liquidation of Loans”.

Assets acquired should initially be recorded in this account at the cost of such assets at foreclosure which is fair value of the asset foreclosed or repossessed. Subsequent to foreclosure, the records

should reflect the asset at the lower of (a) fair value minus estimated costs to sell, or (b) cost at the time of foreclosure.

Generally accepted accounting principles require that... such determination should be made on an individual asset basis. If the fair value of the asset minus the estimated costs to sell the asset is less than the cost of the asset, the deficiency should be recognized as a valuation allowance, “Allowance for Impairment Loss”. If the fair value of the asset subsequently increases and the fair value of the asset minus the estimated costs to sell the asset is more than its carrying amount, the valuation allowance should be reduced, but not below zero. Increases or decreases in the valuation allowance should be charged or credited to “Gain (Loss) Due to Disposition/Impairment of Assets”.

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

If the number of loans that has been transferred to this account exceeds one, then it is necessary to establish a subsidiary account for control purposes. The value of each item should be adjusted to the lower of (a) fair value minus estimated costs to sell, or (b) cost.

If any income is derived (expenses incurred) from the property while the collateral property is in the possession or under the control of the credit union, the net of such revenues and expenses related to operating or holding foreclosed assets held for sale should be credited or charged to income as a gain or loss on holding the assets. Credit union officials must keep in mind that these repossessed assets are to be held only temporarily. Maintaining such property permanently in an income-producing manner is beyond the permitted powers of a federal credit union.

Although not required, it is a good procedure to forward to the member a brief accounting record of the loan reflecting sale and application of the

collateral. Such a procedure can minimize unnecessary questions and possible lawsuits arising from misunderstandings with members.

Illustrative Entries

a) To record the cost of an asset acquired at foreclosure which is the fair value of the asset foreclosed (when the obligation of the borrower has been canceled):

Dr.-Assets Acquired in Liquidation of Loans	\$375.00	
Dr.-Allowance for Loan Losses	25.00	
Cr.-Loans		\$400.00

Note: When the outstanding loan balance exceeds the fair value of the collateral at foreclosure, the remaining loan balance (the difference) should be charged off to the allowance for loan losses.

b) To recognize an impairment loss by writing down the carrying value of the asset to the lower of (i) fair value less cost to sell the asset or (ii) cost at time of foreclosure; write-down to \$175 in this case:

Dr.- Gain (Loss) Due to Disposition/Impairment of Assets	\$200.00	
Cr. Allowance for Impairment Losses		\$200.00

c) To record the disposition of assets acquired in liquidation of loans -- assume assets carried in "Assets Acquired in Liquidation of Loans" above are sold for \$150.00:

Dr.-Cash	\$150.00	
Dr.-Allowance for Impairment Losses	200.00	
Dr.-Gain (Loss) Due to Disposition/Impairment Of Assets	25.00	
Cr.-Assets Acquired in Liquidation of Loans		\$375.00

Note: If, as a condition of the sale, the credit union accepts a note for part or all of the purchase price, the note should be accounted for in "Notes and Contracts Receivable". Refer to "Unamortized Discount on Sale of Assets" in Deferred Credits section of the Liabilities chapter for further explanation and illustrative entries.

Allowance for Impairment Losses

This account represents the impairment loss recognized for assets acquired in liquidation of loans, subsequent to foreclosure. It is the difference in cost (fair value) at the time of foreclosure and the current fair value less estimated costs to sell the asset. Refer to "Assets Acquired in Liquidation of Loans" for further explanation and illustrative entries.

PROPERTY AND EQUIPMENT

Under Section 107(4) of the Federal Credit Union Act, credit unions are authorized to purchase, hold and dispose of property necessary or incidental to their operations. Refer to Part 701.36 of the National Credit Union Administration Rules and Regulations for limitations on amounts which may be invested in fixed assets and on the sources from which real property can be acquired without prior approval of the National Credit Union Administration Board.

LAND

This account reflects the costs to the credit union of land owned by it, except that any land acquired in connection with the liquidation of loans should be recorded in "Assets Acquired in Liquidation of Loans".

When the credit union purchases land, the cost should be recorded in this account. Cost should include the purchase price plus any incidental costs incurred in order to obtain title to the land and place it in condition for use. In combination purchases where land and buildings are acquired in a single transaction, the cost of the land should be recorded in this account based on an estimate of its value at the time of acquisition and the balance of the purchase cost should be recorded in "Building".

Upon disposition of the land and building, the balances for the property recorded in this account and in "Allowance for Depreciation of Building" should be cleared, and any gain or loss credited or debited to "Gain (Loss) Due to Disposition/Impairment of Assets".

Illustrative Entries

a) When land is purchased, record the entry for the cost incurred as follows:

Dr.-Land	\$15,000	
Cr.- Cash		15,000

Note: If a combined purchase of both land and building is made, the amount charged to this account should be based on an estimate of the portion of the overall cost properly attributable to the value of the land based on fair market value.

b) When land carried at \$15,000 is disposed of for an \$18,000 sales price:

Dr.-Cash	\$18,000	
Cr.-Land		15,000
Cr.-Gain (Loss) Due to Disposition/Impairment of Assets		3,000

c) If a combined sale of land and building is made for \$65,000, and the land carrying value is \$15,000, and the building carrying value is \$60,000, with accumulated depreciation of building of \$20,000, the entry would be:

Dr.-Cash	\$65,000	
Dr.-Allowance for Depreciation of Building	20,000	
Cr.- Land		\$15,000
Cr.-Building		60,000
Cr.-Gain (Loss) Due to Disposition/Impairment of Assets		10,000

Detailed Transactions

Debit:

a) With purchase cost of land and other charges related to acquisition. (In combined purchase of land and building, debit this account with the estimated fair market value of the land.)

Credit:

a) With book value of land at time of disposition.

BUILDING

A federal credit union may purchase or construct a building for its use, provided the building is necessary and incidental to its operation and the purchase is in compliance with Section 701.36 of NCUA Rules and Regulations. This account should reflect all costs related to the acquisition of the building plus the cost of any additions and improvements of a permanent nature which increase the value of the building.

Depreciation

The following are acceptable useful lives for new buildings based on type of construction:

<u>Type of Construction</u>	<u>Useful Life</u>
Concrete & Steel	30-55 years
Masonry	25-45 years
Wood Frame	20-40 years
Portable Units	15-30 years

In selecting a specific useful life within the above ranges, the board of directors should consider such other factors as anticipated use, climatic conditions, economic conditions within the surrounding area, possible future uses of the building site and the surrounding area, and present and future accessibility of the site for the membership. The credit union's files should contain written documentation and support for the period of depreciable life selected, with attention given to all of these factors.

The remaining useful life of a used building should be a reasonable estimate based on the age and condition of the building at the time of acquisition by the credit union.

For purposes of determining the periodic depreciation charge, it is recommended that the salvage value be limited to 10 percent of the cost of the depreciable property (excluding the cost of land) unless a higher salvage value is determined by an independent qualified appraiser at the time of acquisition.

Depreciation charges as a minimum should be recorded at least quarterly or at the end of the regular share account dividend period if it is longer than quarterly. Where the dividend period is more frequent than monthly, the depreciation charge may be recorded on a monthly basis. In determining the periodic depreciation charge, the board may select any of the generally accepted methods of depreciation, such as straight-line, sum-of-the-years digits, or declining balance methods. The depreciation should be credited to "Allowance for Depreciation of Building." The balance in "Allowance for Depreciation of Building" should be deducted from the balance in the "Building" account and the net reflected as the value of the Building in the monthly Statement of Financial Condition.

Expenses

Expenses, including depreciation, incurred in maintaining the building should be recorded in the appropriate expense classification under "Office Occupancy Expenses". Any incidental income received from the building should be credited to "Other Nonoperating Income (Expense)".

Records

All required supporting papers should be kept in the permanent files, including such items as the deed, abstract of title or title insurance policy, and settlement papers. The board of directors must determine that all necessary insurance is purchased, including at least public liability and fire insurance, and should periodically ascertain the need for additional coverage.

Sale of Land and Building

Ordinarily, when a credit union sells its office building, it does so for cash. If, however, as a condition of the sale, the credit union accepts a note for part of the purchase price, the note should be accounted for in "Notes and Contracts Receivable", as discussed in the description of that account.

Illustrative Entries

a) When a building is acquired, the purchase price (excluding value of land purchased and recorded in "Land") plus incidental expenses related to the acquisition, and any expenditures made immediately following acquisition to place the building in condition for use by the credit union should be recorded:

Dr.-Building	\$350,000	
Cr.- Cash		\$350,000

Note: If the acquisition involves borrowing by the credit union secured by a mortgage on the building, the credit should be to "Mortgage Notes Payable" instead of to "Cash".

Detailed Transactions

Debit:

- With purchase cost of building plus amount of related costs incidental to acquisition of title.
- With expenditures made immediately following acquisition to place the building in condition for use by the credit union.
- With the cost of improvements to the building.

Credit:

- With the current carrying value of the building at the time of disposition.

Allowance for Depreciation of Building

This account represents the amount provided for depreciation or obsolescence of a building owned

by the credit union, exclusive of buildings carried as "Assets Acquired in Liquidation of Loans".

The carrying value of the building less estimated eventual salvage value should be depreciated by periodic charges to operating expense over the building's estimated life. The depreciation computation may be made monthly, quarterly, semiannually or annually, but as a minimum, should be made for each regular share account dividend period.

Illustrative Entries

a) To record quarterly straight-line depreciation: building carrying value \$2,000,000; estimated life is 40 years; and anticipated salvage \$200,000. Quarterly depreciation is calculated as \$2,000,000 less \$200,000 divided by 160, representing the number of quarterly periods, equaling periodic depreciation costs of \$11,250:

Dr.-Depreciation of		
Buildings	\$11,250	
Cr.-Allowance		
for Depreciation of		
Buildings		\$11,250

b) To record sale of building and land see illustrative entry c) under the description of "Land."

Impairment of Long Lived Assets

If the credit union experiences a significant decrease in the market value of a long-lived asset (e.g., building) that it expects to hold and use, the carrying value of the asset shall be written down to its fair value. The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than a forced or liquidation sale. The loss will be recognized as a current operating expense, "Gain (Loss) Due to Disposition/Impairment of Assets". After an impairment is recognized, the reduced carrying amount of the asset shall be accounted for as its new cost. The new cost shall be depreciated over the asset's remaining useful life. Restoration of previously recognized impairment losses is prohibited.

All long-lived assets that the credit union plans to dispose of, whether by sale or abandonment, shall be reported at the lower of carrying amount or fair value less cost to sell. An example may be an obsolete building acquired in a merger. Once the asset is written down to fair value less cost to sell (if lower than carrying amount), it shall not be depreciated while it is held for disposal. Subsequent adjustments to the fair value less cost to sell may be made as long as the carrying amount of the asset does not exceed the carrying amount of the asset before the original adjustment was made to reflect the decision to dispose of the asset. The gain/loss will be recognized as a current operating expense, "Gain (Loss) Due to Disposition/Impairment of Assets".

FURNITURE AND EQUIPMENT

This account represents the cost of furniture, fixtures and equipment. The cost of furniture, fixtures, and equipment shall be amortized over the estimated useful life through periodic charges to depreciation expense using any of the generally accepted methods of depreciation, except the reverse sum-of-the-years digits method.

Charges for depreciation may be made monthly, quarterly, semiannually, or annually, at the option of the credit union, but as a minimum, should be recorded at the end of each regular share account dividend period. The depreciation may be recorded under either the unit or the composite-life basis of depreciation as described under "Allowance for Depreciation of Furniture and Equipment".

a) Under the unit basis of depreciation, each depreciable fixed asset is depreciated separately based on its estimated useful life less estimated salvage value. When an asset is disposed of, the cost should be eliminated from this account and the accumulated depreciation to date should be cleared (by debit) to "Allowance for Depreciation of Furniture and Equipment". The difference between the net carrying value of the asset (the cost less accumulated depreciation to date) and any proceeds of sale received for the asset will represent net gain or loss and should be recorded in "Gain (Loss) on Disposition of Assets". As long as an asset has a salvage or useful value, the depreciation credit to

"Allowance for Depreciation of Furniture and Equipment" may not result in the asset being carried on the credit union's books at less than \$1.

b) Under the Composite Method of depreciation, groups of similar fixed assets will be depreciated over their estimated average useful lives by periodic charges to expense and credits to "Allowance for Depreciation of Furniture and Equipment". When individual items of furniture and equipment are disposed of, this account should be credited for the cost of the assets retired and the same amount less proceeds received (if any) should be charged to the "Allowance for Depreciation of Furniture and Equipment". No gain or loss should be recognized in the accounts since the composite rates used contemplate that items in the groups will be retired both before and after the expiration of the estimated average useful life.

An exception may be made and gain or loss recognized under the procedure described in the foregoing paragraph when retirements are abnormal and are material in amount, since the composite rates do not anticipate such retirements. Also, under this depreciation method, the accumulated depreciation allowance account should never be permitted to exceed the fixed asset amount.

To simplify recordkeeping, furniture and equipment items costing less than a fixed amount (e.g., \$200) that is established by the board of directors should be expensed by a debit to "Other Office Operations Expenses" at the time of purchase.

Entries in the Journal and Cash Record

This account is debited in the "Miscellaneous-Debit" column with the cost of furniture and equipment purchased by the credit union. This account is credited in the "Miscellaneous-Credit" column with the cost of any items disposed of by sale or otherwise.

Posting to the General Ledger

Entries in this account are posted individually from the "Miscellaneous" columns of the Journal and Cash Record. Items recorded in this account

should be concisely identified in the "Explanatory Remarks" column. A memorandum notation should be made in the "Explanatory Remarks" column of any item disposed of so this account will provide a record of all furniture and equipment on hand.

Furniture and Equipment Acquired by Trade

In some cases when a new asset is purchased, the credit union will exchange or trade-in the current asset. This is common with computer equipment. Unless the book value and the fair market value are equal, the credit union must record a gain or loss on this exchange. This gain or loss should be computed as the difference between the fair market value and the book value of the equipment given up. When furniture and equipment are traded for a new item(s), the book value of the newly acquired asset is the fair market value of the asset traded plus the amount of cash paid or debt incurred. If, as a result of this accounting method, the carrying value of the new asset exceeds its reasonable market value, the board of directors should authorize an immediate depreciation charge against the new asset to reduce the carrying value to the asset's market value.

Gain or Loss in the Year of Sale of an Asset

If an asset is sold during the year, a gain or loss will occur unless the asset is sold for book value (the original cost less depreciation). In order to compute this gain or loss, the following steps should be followed:

- *Record depreciation up to date.* Since the asset was sold prior to yearend, it is necessary to allocate depreciation up to the date of sale.
- *Compute book value.* The book value is the original cost to the credit union, plus any additions to the asset that have not been expensed, less any depreciation taken to date. This amount is the book value.
- *Determine proceeds from the sale.* This is the amount received by the credit union for the sale of the asset. If the property is abandoned or given away, the proceeds will be zero. If property is received as a part of the sale, the

sale may be considered a trade-in. Trade-ins are covered further in this section.

- *Determine gain or loss.* If the proceeds from the sale are greater than the computed book value, the sale is a gain. The gain is the difference between the proceeds and the book value. If the proceeds from the sale is less than the computed book value, then the sale is a loss.

Illustrative Entries

a) When furniture and equipment is acquired:

Dr.-Furniture and Equipment	\$500	
Cr.- Cash		\$500

b) When furniture and equipment is depreciated:

Dr.-Depreciation of Furniture and Equipment	\$25	
Cr.-Allowance for Depreciation of Furniture and Equipment		\$25

c) When furniture and equipment is sold at a loss, where unit basis of depreciation is followed. Assume an office machine sold for \$200; original cost of \$1,800; less accumulated depreciation to date of \$1,400.

Dr.-Cash	\$200	
Dr.-Allowance for Depreciation of Furniture and Equipment	1,400	
Dr.-Gain (Loss) Due to Disposition/Impairment of Assets	200	
Cr.-Furniture and Equipment		\$1,800

d) When furniture and equipment is sold at a loss, where composite-life basis of depreciation is followed. Assume a typewriter sold for \$200; original cost of \$1,800 accumulated depreciation to date of \$1,400:

Dr.-Cash	\$200	
Dr.-Allowance for Depreciation of Furniture and Equipment	1,600	
Cr.-Furniture and Equipment		1,800

e) When furniture and equipment is sold at a gain, where unit basis of depreciation is followed. Assume a typewriter sold for \$600; original cost of \$1,800; less accumulated depreciation to date of \$1,400.

Dr.-Cash	\$600	
Dr.-Allowance for Depreciation of Furniture and Equipment	1,400	
Cr.-Gain (Loss) Due to Disposition/Impairment Of Assets		\$200
Cr.-Furniture and Equipment		1,800

f) When an asset is traded in for a new asset and a gain has occurred. Assume the credit union acquires a new typewriter for \$1,000 cash and the trade-in of an old typewriter. The original cost of the old typewriter is \$1,800 and accumulated depreciation to date is \$1,400. The book value of the old typewriter is \$400 and the fair market value is \$600.

Dr.-Furniture and Equipment (new)	1,000	
Dr.-Allowance for Depreciation of Furniture and Equipment		1,400
Cr.-Gain (Loss) Due to Disposition/Impairment of Assets		400
Cr.-Furniture and Equipment (old)		1,800
Cr.-Cash		600

Detailed Transactions

Debit:

a) With cost of such assets purchased.

Credit:

a) With cost of such assets upon sale or other disposition.

Allowance for Depreciation of Furniture and Equipment

This account reflects the amount provided for depreciation or obsolescence of the respective assets. See description of "Furniture and Equipment" for a description of the unit and composite-life basis of depreciation as well as for the method to be followed when assets are disposed of under each such basis of depreciation. The balance of this account should be deducted from the balance of "Furniture and Equipment" when Statements of Financial Condition are prepared.

Illustrative entries for this allowance are described in the "Furniture and Equipment" section.

Outlined on the next page are acceptable depreciation ranges expressed as a lower limit, a generally accepted period, and an upper limit for certain types of assets.

The cost of furniture, fixtures and equipment shall be amortized over the estimated useful life through periodic charges to depreciation expense using any of the generally accepted methods of depreciation except the reverse sum-of-the-years digits method. The cost of computer software shall be amortized on a straight-line basis unless another basis is more representative of the software's use.

Sample Depreciation Methods

Straight Line

This method is the most popular among credit unions and the simplest to apply. Salvage value is deducted from the cost. The remaining amount is divided by the useful life of the asset, and that amount is the yearly depreciation expense. The amount of the depreciation will remain the same until the asset has been depreciated down to salvage value.

To illustrate this method, assume that the credit union purchases an asset for \$10,000 with a useful life of 5 years.

The estimated average value of the assets is \$1,000. The yearly depreciation would be \$1,800 computed as follows:

Cost of Asset:		\$10,000
Less Salvage Value:		1,000
Depreciable Amount:		<u>\$ 9,000</u>
Depreciation, 20X1	\$1,800	(\$9,000/5 = \$1,800)
Depreciation, 20X2	\$1,800	(\$9,000/5 = \$1,800)
Depreciation, 20X3	\$1,800	(\$9,000/5 = \$1,800)
Depreciation, 20X4	\$1,800	(\$9,000/5 = \$1,800)
Depreciation, 20X5	\$1,800	(\$9,000/5 = \$1,800)

If an asset is purchased or sold during the year, it becomes necessary to expense only a portion of the yearly depreciation expense. To illustrate, assume that the above asset was purchased on October 1, 20X1. The amount of the expense for that first year would only be \$450 (\$1,800 x 3/12).

Instead of computing depreciation on a yearly basis, months can be substituted for years. Instead of computing a yearly depreciation rate, the credit union can compute a monthly rate by dividing the cost of the asset (less salvage value) by the number of months in the useful life. In the above example,

DEPRECIATION AMORTIZATION PERIODS

	Lower Limit	Generally Accepted Period	Upper Limit
Office Furniture, Fixtures & Equipment: Includes furniture, fixtures and equipment which are not a structural component of a building, i.e., desks, files, safes, and communication systems	8	10	12
Information Systems: Includes computers and their peripheral equipment used in administering normal business transactions and the maintenance of records, their retrieval and analysis	5	6	7
Data Handling Equipment Except Computers: Includes typewriters, calculators, accounting machines, Copiers, and other duplicating equipment, automated teller Machines, etc.	5	6	7
Computer Software Costs	5	5	5
Automobiles and Van	2.5	3	4
Buses	7	9	11
Light General Purpose Trucks (Less than 13,000 lbs.)	3	4	5
Heavy General Purpose Trucks	5	6	7
Land Improvements: Includes sidewalks, parking lot surfacing, drainage facilities, sewers, fences and landscaping shrubbery		20	

the monthly rate of depreciation would be \$150, (\$9,000 / 60 months = \$150).

Sum-of-Year-Digits

This method is designed to provide more depreciation expense in the first few years of ownership and less in the last few years. This is called an accelerated method of depreciation. It is most useful in leveling out expenses over the life of an asset. As an asset ages, repair and maintenance costs increase. An accelerated depreciation method

should provide high depreciation costs when repair costs are low and low depreciation costs when repair costs are high. Total costs for an asset (depreciation and repairs and maintenance) should then remain somewhat level over its useful life.

To compute depreciation under the sum of the years digits method, the cost of an asset (less salvage value) is multiplied by a fraction each year to determine that year's depreciation expense.

The denominator (bottom line) of this fraction is the sum of each of the years in the useful life of an asset. If the useful life of an asset is 3, then the sum of the years is 6 (3 + 2 + 1). If the useful life of an asset is 4, then the sum of the years is 10 (4 + 3 + 2 + 1). This part of the fraction will stay the same each year.

The numerator (top number) of this fraction is the number of years of useful life remaining for the asset. This part of the fraction will change each year.

Example 1: Assume a \$10,000 asset with a useful life of 5 years and a salvage value of \$1,000. The depreciation expense is computed as follows:

	Fraction Amount	Depreciable Amount	Depreciation Expense
Depreciation 20X1	5/15	\$9,000	\$3,000
Depreciation 20X2	4/15	\$9,000	2,400
Depreciation 20X3	3/15	\$9,000	1,800
Depreciation 20X4	2/15	\$9,000	1,200
Depreciation 20X4	1/15	\$9,000	600
Total Depreciation			<u>\$9,000</u>

The fractions for the following years are:

Year	4 Year Useful Life	5 Year Useful Life	6 Year Useful Life
1	4/10	5/15	6/21
2	3/10	4/15	5/21
3	2/10	3/15	4/21
4	1/10	2/15	3/21
5	--	1/15	2/21
6	--	--	1/21

Months (or quarters) may be substituted for years if the credit union elects to compute monthly (or quarterly) depreciation.

When a credit union computes depreciation on a yearly basis, it becomes necessary to record only a portion of that depreciation in the year of purchase and in the year of sale of the asset. This can be done by months or by days.

Assume that the credit union purchases an asset on April 1, 1981. The asset, cost \$12,500, has a salvage value of \$500 and a useful life of 3 years, and the credit union elects to use the sum of the years digits method of depreciation. Since the asset was purchased one-fourth of the way through the first year, only three-fourths of the depreciation should be taken in the first year, the remainder should be taken in the second year. Each additional year must also be allocated as well.

Year	Fraction	Depreciable Amount	Depreciable Expense
1	3/6	\$12,000	\$ 6,000
2	2/6	12,000	4,000
3	1/6	12,000	2,000
Total Depreciation Expense			<u>\$12,000</u>

Calendar Year	1981	1982	1983	1984
1st year $\frac{3}{4} \times 6,000$	4,500			
1st year $\frac{1}{4} \times 6,000$		1,500		
2nd year $\frac{3}{4} \times 4,000$		3,000		
2nd year $\frac{1}{4} \times 4,000$			1,000	
3rd year $\frac{3}{4} \times 2,000$			1,500	
3rd year $\frac{1}{4} \times 2,000$				500
Total Expense for Year	\$4,500	\$4,500	\$2,500	\$500

Declining Balance

This depreciation method is also an accelerated method of depreciation providing for additional depreciation expense in the early years. Under this method, a fixed percentage is multiplied by the declining balance of the particular asset. The rate of depreciation is a number between 100 and 200 percent of the straight-line rate. The following steps should be used to determine depreciation under the declining balance method.

Facts: The credit union purchased an asset for \$10,000 with a useful life of 5 years. The estimated salvage value of the asset is \$1,000.

a) Determine the straight-line rate:

The straight-line rate is determined by the following formula: 1 divided by the useful life of the asset. For example, an asset with a useful life of 5 years would have a straight-line rate of 20 percent.

b) Multiply the straight line rate by a percentage between 100 and 200:

Assume that a credit union wanted to use a rate of 150 percent of the straight-line rate. On an asset with a useful life of 5 years, then 150 percent of the straight-line rate would be 30 percent (1 divided by 5 has a straight-line rate of 20 percent, and 150% of that rate is 30 percent).

c) Multiply the depreciation rate times the declining balance of the asset (ignoring salvage value until the last year). To determine a years depreciation expense, multiply the depreciation rate times the declining balance (the original cost less prior years depreciation, if any). The declining value must never fall below the estimated salvage value of the asset. Also, in the last year of useful life, the asset must be written down to salvage value.

Purchased 1/1/X1	Depreciation	Balance
		\$10,000
Depreciation, 20X1 (\$10,000 x 30%)	\$3,000	7,000
Depreciation, 20X2 (\$ 7,000 x 30%)	2,100	4,900
Depreciation, 20X3 (\$ 4,900 x 30%)	1,470	3,430
Depreciation, 20X4 (\$ 3,430 x 30%)	1,029	2,401
Depreciation, 20X5 (Write-down to salvage value)	1,401	1,000
Total Depreciation	\$9,000	

In the event that an asset is purchased or sold during the year, only a portion of the year's expense should be recorded. In the above example, if the asset has been purchased on July 1, 20X1. The depreciation for the first year would be only \$1,500

(6/12 x \$3,000). In subsequent years, the credit union should continue to use the 30 percent rate against the declining balance to determine the depreciation expense for the year.

Comparison of Three Methods

	Straight-Line	Sum of the Year Digits	Declining Balance
Depreciation, 20X1	\$1,800	\$3,000	\$3,000
Depreciation, 20X2	1,800	2,400	2,100
Depreciation, 20X3	1,800	1,800	1,470
Depreciation, 20X4	1,800	1,200	1,029
Depreciation, 20X5	1,800	600	1,401
Total Depreciation	\$9,000	\$9,000	\$9,000

Composite Depreciation Method

This method allows economic lives to be applied to broad classes of assets rather than to detailed items of depreciable property. Composite or group depreciation is a process of averaging the economic lives of a number of property units and taking depreciation on the entire group as if it were a unit. The depreciation rate is computed determining the depreciation for 1 year for each item or each group of similar items and dividing the total depreciation thus obtained by the total cost or other basis of the assets. This average rate is to be used as long as

later additions, requirements, or replacements do not substantially alter the relative proportions of different types of assets in the accounts. An example of the computation of a composite rate under the straight-line method follows:

On January 2, a desk was bought for \$500. It has an estimated useful life of 10 years. A calculator was also purchased for \$500. The life was 5 years. Estimated salvage value was 20% of cost on both items. The average rate of depreciation is computed as follows:

Asset	Date Acquired	Original Cost	Estimated Salvage Value	Amount To Be Depreciated	Annual Economic Life	Annual Depreciation
Desk	1/2	\$ 500	\$100	\$400	10	\$ 40
Calculator	1/2	500	100	400	5	80
		<u>\$1,000</u>	<u>\$200</u>	<u>\$800</u>		<u>\$120</u>

(Average rate of depreciation (\$120 divided by \$1,000) = 12%)

LEASEHOLD IMPROVEMENTS

This account represents the cost to the credit union of leasehold improvements which are currently being used in connection with its operations. Leasehold improvements are improvements made to the lessor's property which is occupied or otherwise used by the lessee credit union under a lease or rental agreement. The leasehold improvements are paid by the credit union, but they revert to the lessor upon termination of the lease. Leasehold improvements frequently represent significant payments by the credit union, and for this reason, a separate asset account, "Leasehold Improvements", should be established for amortizing these improvements.

Leasehold improvements can arise when property has been leased and additions, improvements, or alterations are made to make the property more usable by the credit union. Funds expended by the credit union to improve or alter buildings provided for the credit union's use on military installations should be recorded as leasehold improvements. This account also may be charged with the cost of renovations (including repair and decoration costs) made when premises are initially occupied for the purpose of making the property usable by the credit union.

Leasehold improvements should be amortized over the period of the lease giving recognition to renewal options or the estimated life of the improvements, whichever period is the shorter. In the case of premises occupied without a formal lease, the amortization should be made over the estimated life of the improvements, unless the

directors have a definite basis for determining the period the credit union will occupy the premises. The amortization should be made over the life of the improvements or the estimated period of occupancy, whichever period is the shorter. This requirement is applicable unless the directors have a definite basis for determining the period that the credit union will occupy the premises.

The amortization of leasehold improvements should be made by charging the expense, "Amortization of Leasehold Improvements", and crediting "Allowance for Amortization of Leasehold Improvements". The later account does not apply to funds expended to construct buildings on Department of Defense installations. Those funds need to be recorded in "Leased Assets Under Capital Lease".

If the credit union does not use the leasehold improvements or abandons the premises prior to complete amortization of leasehold improvements, the accumulated amortization to date should be cleared from "Leasehold Improvements" and "Allowance for Leasehold Improvements" and the difference charged to "Gain (Loss) on Disposition/Impairment of Assets".

Entries in the Journal and Cash Record

All entries debiting or crediting this account should be recorded in the "Miscellaneous" columns.

Illustrative Entries

- a) With the cost of leasehold improvements:

Dr.-Leasehold Improvements	\$15,000	
Cr.-Cash		\$15,000

b) With the capitalized value of leasehold improvements when the lease expires; assume \$15,000 cost of improvements and amortization previously recorded of \$15,000:

Dr.-Allowance for Amortization of Leasehold Improvements	\$15,000	
Cr.-Leasehold Improvements		\$15,000

c) If the leased premises are vacated by the credit union before the leasehold improvements are fully amortized; assume \$15,000 cost of improvements and amortization to date of \$12,000:

Dr.-Gain (Loss) on Disposition/ Impairment of Assets	\$ 3,000.00	
Dr.-Allowance for Amortization of Leasehold Improvements	12,000.00	
Cr.-Leasehold Improvements		\$15,000.00

Detailed Transactions

Debit:

a) With cost of leasehold improvements when incurred.

Credit:

a) With cost of leasehold improvements carried in this account upon termination of the lease, when the premises are vacated by the credit union, or when leasehold improvements are charged off for any other reason.

Allowance for Amortization of Leasehold Improvements

This account reflects the accumulated allowance for leasehold improvements. The balance of this account should be deducted from the balance of "Leasehold Improvements" when statements of financial condition are prepared.

Entries in the Journal and Cash Record

All entries affecting this account should be entered in the "Miscellaneous" columns of the Journal and Cash Record.

Detailed Transactions

Credit:

a) Periodically, with amount necessary to amortize the leasehold improvement asset account over the period of the lease, or the estimated value of the improvements, whichever is shorter.

Debit:

a) With amount of accumulated amortization upon termination of the lease or when leasehold improvements are charged off for any other reason.

NCUSIF DEPOSIT

INVESTMENT IN NCUA SHARE INSURANCE CAPITALIZATION FUND

This account is used to record deposits into and redistributions from the National Credit Union Share Insurance Fund (NCUSIF). The amount deposited or redistributed is based on the insured shares of a credit union on December 31. NCUSIF deposits normally equal 1% of a credit union's total insured shares. Invoices are provided to federally insured, state-chartered credit unions and federally chartered credit unions annually; for credit unions with \$50 million or more in assets, invoicing is semi-annually. These invoices itemize the amounts due to the NCUSIF. The invoice for federally chartered credit unions also includes the

computation of the amount due for the annual operating fee.

Illustrative Entries

a) To record payment of the capitalization deposit adjustment or initial deposit:

Dr.-Investments in NCUSIF	\$1,595.67	
Cr.- Cash		\$1,595.67

b) To record a redistribution of the NCUSIF equity, i.e., when a credit union's shares decrease from the preceding insurance year:

Dr.-Cash	\$75.00	
Cr.-Investments in NCUSIF		\$75.00

Detailed Transactions

Debit:

a) With the amount of payments to the National Credit Union Share Insurance Fund.

Credit:

a) With the amount of a redistribution of NCUSIF equity.

Reference: Rules and Regulations 741.4.

OTHER ASSETS

SERVICING ASSETS

When a credit union sells whole loans or participations in loans, the credit union often retains the right to service the loans. A credit union may also service credit card receivables or other financial assets. This asset category represents the economic value of these servicing rights. Further discussion of this topic is outside the scope of this manual. Credit unions involved in servicing loans or other assets should seek the guidance of an independent accountant.

ACCOUNTS RECEIVABLE

Receivable accounts are used to record claims of the federal credit union for money, goods, or services from other entities or persons. The primary "trade debtors' accounts" of a federal credit union are evidenced by loans to members and other notes and contracts receivable which are discussed in the "Loans" section of this manual.

Payroll Deductions Receivable

This account is used to record payroll receivables from members' employers prior to the credit union's receipt of the funds by check, magnetic or electronic media. A debit balance in this account indicates that an employer's payroll(s) was/were not received on the date(s) agreed upon by the employer and the credit union.

Illustrative Entries

Dr.-Payroll Deductions Receivable		\$25,000
	Cr.-Undistributed Payroll Deductions or Allotments	

Detailed Transactions

Debit:

a) With an estimated amount receivable from an employer that has not been received on the "set date."

Credit:

a) With the similar amount when received from the employer.

Receivables From Officials And Employees

This account is used to record accounts receivable due from officials and employees of the credit union. This account is not used to record loans to members. Examples of receivables might include: travel advances outstanding while an employee is at the CUNA management school and issuance of a second (or duplicate) payroll check to an employee

after the employee reports that the first check was lost or misplaced.

Illustrative Entries

a) To record a travel advance to an employee:

Dr.-Receivables from Officials and Employees	\$500	
Cr.-Cash		\$500

b) To record the employee's claim for travel expenses and application of the advance:

Dr.-Employees' Travel And Conference Expenses	\$555	
Cr.-Receivables from Officials and Employees		\$500
Cr.-Cash		55

Detailed Transactions

Debit:

a) With the amount of a travel advance to an employee attending a credit union related school or conference.

Credit

a) With the actual expenses incurred by an employee attending a credit union related school or conference up to the amount advanced.

Insurance Premiums Receivable

This account is used to record the unpaid balance of amounts due from member-borrowers in payment of reimbursable premiums paid out by the credit union for insurance covering property accepted as security for loans and for life insurance protection (borrowers' protection insurance). Only insurance premiums advanced for which the credit union is to be reimbursed by the borrowers are to be recorded in this account.

This account is not to be used for insurance premiums advanced at the time a loan is made to a member. Such advances should be included as a part of the loan and the grand total set forth in the note. If members desire the credit union to advance such insurance premiums they should apply for a loan which should be processed in the same manner as all other loan applications are handled.

In those cases where it is agreed that the borrower shall provide such insurance and continue it in force during the period the loan is unpaid, it is suggested that a written agreement to this effect, containing an authorization for the credit union to advance the premium for continuing the insurance, be obtained at the time the loan is granted. This agreement may be included in the loan application, the lien instrument, or a separate contract. If interest is to be collected on such advances, provision for the interest should be made in the agreement. In the event the written agreement allows the credit union to add these premium advances to the borrowers' loan balance, the credit union should account for these advances in "Loans" rather than "Insurance Premiums Receivable". "Insurance Premiums Receivable" should also be used to record insurance premium advances made on outstanding "Notes and Contracts Receivable".

Since insurance on property accepted as security for loans is obtained primarily for the benefit of the borrower, it is appropriate to require the borrower to furnish such insurance. If he does not pay the premiums thereon when due, the credit union may advance such premiums, charge them to this account, and collect them later, by reimbursement from the borrower in accordance with an agreement.

Amounts charged to this account represent amounts due from borrowers which are advanced by the credit union to continue insurance coverage when the borrower does not pay the premium when they come due. These amounts should not be confused with funds collected, in advance by the credit union, for remittance to the insurance company for the borrower. Such amounts collected in advance are recorded in "Accounts Payable".

Entries in Journal and Cash Record

This account is debited in the "Miscellaneous Debit" column when a check is issued in payment of the insurance premium involved. This account is credited in the "Miscellaneous-Credit" column with the amounts of funds received from member/borrowers in payment of insurance premiums, and with the charge off of any uncollected items remaining after the related loans are either charged off or security repossessed.

The charge off of such items remaining in this account should be debited to "Miscellaneous Operating Expenses". Entries covering the charge off of insurance premiums receivable should be identified as such in the member's Individual Share and Loan Ledger accounts, and recoveries applicable to such items should be recorded in these accounts as memorandum information showing the amount recovered by the credit union, and the date the recovery was received.

Posting General Ledger

Each entry involving this account is posted individually to the General Ledger from the "Miscellaneous" columns of the Journal and Cash Record. The "Explanatory Remarks" column should show clearly the necessary dates of entries posted to this account such as the name of the individual from whom the amount is receivable. If separate columns are used in the Journal and Cash Record for entries to this account, the total amounts of these columns should be debited and credited respectively to the "Insurance Premiums Receivable" account in the General Ledger at the close of each month.

Posting to Subsidiary Ledger

If the number of these items necessitates a subsidiary ledger, a separate ledger sheet may be kept for each member involved. Appropriate headings identifying the account and person connected should be provided.

Debit entries for amounts received in payment of premiums due from borrowers are posted from Cash Received Vouchers to the Journal and Cash Record debit column of either the "Miscellaneous"

or "Insurance Premium Receivable" columns. Credit entries, such as uncollected amounts charged off, are posted from "Miscellaneous Credit" column or from the "Insurance Premiums Receivable" credit column of the Journal and Cash Record, whichever column is used by the credit union for credit entries to this account.

The total of the balances of the subsidiary accounts should equal the balance of the "Insurance Premiums Receivable" General Ledger Account and should be proved therewith at least monthly. The monthly lists of these balances should be retained as part of the credit union's records.

The credit union may find it advisable to make an entry in the "Memorandum" column of the borrower's individual loan ledger account in order to avoid the possibility of overlooking collection of these premiums from borrowers.

Illustrative Entries

a) When a check is issued by the credit union in payment of an insurance premium that is reimbursable by the borrower:

Dr.-Insurance Premiums		
Receivable	\$50	
Cr.-Cash		\$50

b) When the member-borrower reimburses the credit union for the insurance premium paid:

Dr.-Cash	\$50	
Cr.-Insurance Premiums		
Receivable		\$50

c) When the insurance premium receivable is charged to the member's loan account:

Dr.-Loans	\$50	
Cr.-Insurance Premiums		
Receivable		\$50

Detailed Transactions

Debit:

a) With the issuance of a check in payment of an insurance premium that is reimbursable by the borrower.

Credit:

a) With a payment from the borrower to reimburse the credit union for the insurance premium paid.

b) With a charge of the premium payment to the member's share or loan account.

U.S. Savings Bonds Redeemed Receivable

Section 121 of the Federal Credit Union Act provides that federal credit unions may act as redemption or repurchase agents of the U.S. Treasury Department for the sale of U.S. Savings Bonds. Only those credit unions that have applied to the U.S. Treasury and have been approved as issuing and/or payment agents may engage in savings bonds transactions. Both members and nonmembers of the credit union can participate in these transactions.

This account should reflect amounts due from the U.S. Treasury for U.S. Savings Bonds redeemed. When payments are made to redeem bonds, the amounts disbursed should be debited to "U.S. Savings Bonds Redeemed Receivable". When remittances are received from the Federal Reserve Bank for the value of the bonds transmitted for reimbursement, this account should be credited. Refer to the "Cash and Cash Equivalents" section of this manual for further explanation and discussion relative to U.S. Savings Bonds.

Illustrative Entries

a) When U.S. Savings Bonds are redeemed by a member for cash or credit to shares:

Dr.-U.S. Savings Bonds Redeemed Receivable	\$19.75	
Cr.-Cash		\$19.75

or

Cr.-Regular Shares	\$19.75
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b) When a remittance is received from the Federal Reserve Bank for the value of redeemed bonds and notes shipped:

Dr.-Cash	\$19.75	
Cr.-U.S. Savings Bonds Redeemed Receivable		\$19.75

Detailed Transactions

Debit:

a) With the payment made to a member for the redemption of a U.S. Savings Bond. The payment could be made from cash or recorded as a deposit to the member's share account.

Credit:

a) With a payment from the Federal Reserve Bank for the value of the redeemed savings bonds.

TIL Bond Claim Receivable

This account reflects the unpaid balance due the credit union for bond claims filed for losses incurred as the result of interest overcharges that were in excess of the provisions of Regulation Z.

Illustrative Entries

a) To record potential bond claim due to the credit union from the bonding company to achieve lump sum reimbursement for interest overcharges under Regulation Z:

Dr.-Truth in Lending Bond Claim Receivable	\$10,000	
Cr.-Shares		\$10,000
or		
Cr.-Cash		\$10,000

b) To clear the receivable account when the bond claim is paid, assuming the full amount has been received:

Dr.-Cash	\$10,000	
Cr.-Truth in Lending Bond Claim Receivable		\$10,000

Detailed Transactions

Debit:

a) With amounts due the credit union, from interest overcharges under Regulation Z.

Credit:

a) With amounts received in reimbursement of payments made by the credit union.

TIS Bond Claim Receivable

This account reflects the unpaid balance due the credit union for bond claims filed for losses incurred under the National Credit Union Administration Rules and Regulations, Part 707.

Illustrative Entries

a) To record potential bond claim due to the credit union from the bonding company:

Dr.-Truth in Savings Bond Claim Receivable	\$10,000	
Cr.-Shares		\$10,000

b) To clear the receivable account when the bond claim is paid, assuming the full amount has been received:

Dr.-Cash	\$10,000	
Cr.-Truth in Savings Bond Claim Receivable		\$10,000

Detailed Transactions

Debit:

a) With amounts due the credit union, from dividend underpayments, overpayments, and/or disclosure errors under Part 707.

Credit:

a) With amounts received in reimbursement of payments made by the credit union.

Other Accounts Receivable

This account reflects the unpaid balance due the credit union for miscellaneous accounts receivable for which no other specific General Ledger account is provided.

This account should include such items as amounts due from an insurance carrier when losses covered by the insurance are sustained; e.g., robbery, physical property damage, etc. The amount of losses should be charged to this account when incurred and the insurance carrier's reimbursement to the credit union should be credited to the account. Differences, if any, between the loss charged and the reimbursement amount should be written off to the proper expense classification.

This account also should include amounts due the credit union resulting from the sale of a fixed asset.

Illustrative Entries

a) When a miscellaneous account receivable is established representing property repair costs resulting from windstorm damage reimbursable by the insurance carrier:

Dr.-Other Accounts Receivable	\$300	
Cr.-Cash		\$300

b) When a check is received for loss reimbursement from an insurance carrier in the amount of \$275.00:

Dr.-Cash	\$275	
Dr.-Maintenance of Building	25	
Cr.-Other Accounts Receivable		\$300

Detailed Transactions

Debit:

- a) With each accounts receivable due the credit union for which no other specific General Ledger account is provided.

Credit:

- a) With payments received in liquidation of receivables charged to this account.
- b) With the write-off of uncollectible amounts charged to this account with the approval of the board of directors.

PREPAID EXPENSES AND DEFERRED CHARGES

Prepaid Rent

This account is used to record the prepayment of rent for space occupied by the credit union or for the rental of equipment. The account would also be used to record prepaid rent resulting from below market leasing costs under a sale-and-leaseback arrangement. For example, if the annual leaseback costs per the contract were \$225,000, but the annual market rental for the geographic area was \$450,000, \$225,000 would be recorded as prepaid rent and would receive periodic amortization.

Prepaid Share Insurance

This account represents the value of the unexpired portion of the share insurance premiums which should be charged to expense at a subsequent date.

Under Section 202(c) of the Federal Credit Union Act each insured credit union shall pay into the insurance fund, a premium charge equal to one-twelfth of one per centum of the total amount of the

insured shares in such credit union at the close of the preceding insurance year. Normally these premiums are payable in January each year for the insurance coverage for the entire calendar year. Often times, such share insurance premiums are waived by the NCUA Board.

Because of the relative size of this expense amount, credit unions may find it advantageous to prorate the cost over the period to which it applies. Such charges may be made monthly, quarterly, semiannually or annually at the option of credit unions using the Modified Cash basis of accounting. For credit unions using the accrual basis, the charges should be made monthly or, alternatively, at least quarterly or at the end of each regular share account dividend period.

Entries in the Journal and Cash Record

This account should be debited in the "Miscellaneous-Debit" column for the portion of applicable share insurance premiums which is to be amortized over the year and, therefore, not yet charged to expense. It should be credited in the "Miscellaneous Credit" column for the portion of the premium that is charged to expense.

Posting to the General Ledger

All entries in this account should be posted from the "Miscellaneous" columns of the Journal and Cash Record. Each entry should be explained in the "Explanatory Remarks" column of the General Ledger.

Illustrative Entries

- a) When the share insurance premium is paid and the current month's premium is charged to expense:

Dr.-Prepaid Share Insurance	\$220	
Dr.-Share Insurance	20	
Cr.-Cash		\$240

- b) An appropriate portion of premium is periodically charged to expense during the year:

Dr.-Share Insurance	\$20	
Cr.-Prepaid Share Insurance		\$20

Detailed Transactions

Debit:

a) With amount of share insurance premiums applicable to future periods.

Credit:

a) With pro rata amounts of share insurance premiums charged to expense over the period to which the prepaid expense applies.

Other Prepaid Insurance

This account represents the value of the unexpired or prepaid portion of the surety bond and other insurance premiums, except share insurance.

Because of the savings involved, it may be advantageous to the credit union to purchase insurance coverage on more than a 1-year basis and charge the unexpired or prepaid portion of the premium to this account. Then periodic charges can be made to expense for the period to which the insurance is applicable. Such charges may be made monthly, quarterly, semiannually or annually.

A credit union which closes its books more than once a year and which pays substantial annual premiums for insurance, such as Chattel Lien Non-filing Insurance, may also use this account to allocate each month's costs as an expense item.

Borrowers' insurance premiums, life-savings insurance premiums and premiums advanced for members in connection with insurance on chattels which have been accepted as security for loans (see "Insurance Premiums Receivable" should not be charged to this account. Likewise, dividends received on borrowers' and life-savings insurance should not be recorded here.

Illustrative Entries

a) A 3-year surety bond premium is paid; the current year's premium is charged to expense:

Dr.-Other Prepaid Insurance	\$200	
Dr.-Insurance	100	
Cr.-Cash		\$300

b) Appropriate portion of premium is charged to expense during the second year:

Dr.-Insurance	\$100	
Cr.-Other Prepaid Insurance		\$100

Detailed Transactions

Debit:

a) With amount of other insurance premiums applicable to future periods.

Credit:

a) With pro rata amounts of insurance premiums charged to cost over the period to which the prepaid expense applies.

Unamortized Organization Costs

The purpose of this account is to enable new credit unions to charge the cost of organization and original bookkeeping supplies to the expenses of more than one accounting period.

Use of Account

The "Unamortized Organization Costs" account may be debited with the costs of the credit union's organization and the cost of the original order for bookkeeping supplies. The cost should be debited to this account in every case except when they were donated to the credit union. When the supplies are donated, the cost is debited directly to "Miscellaneous Operating Expense" and the donation credited to "Other Nonoperating Income (Expenses)."

This account is an asset account and is shown as such on the Statement of Financial Condition of the credit union. At designated times to be determined by the board of directors, which may be monthly, quarterly, semiannually, or annually, charges to expense to reduce the amount set up as an asset are made as described below. In any event, the entire amount should be written off not later than the end of the second year following the year in which the credit union is chartered. It is recommended that the entire amount be written off as soon as it can be absorbed without appreciably affecting the earnings of the credit union.

Entries of Journal and Cash Record

Debit this account in the "Miscellaneous-Debit" column with the cost of the original order for bookkeeping supplies. Whenever it is decided to write off an amount, debit "Miscellaneous Operating Expenses" and credit this account as a "Miscellaneous-Credit".

Posting to General Ledger

Entries to this account are posted individually as "Miscellaneous" in the Journal and Cash Record.

Illustrative Entries

a) When the invoice is received for the original order for bookkeeping supplies, but the check is not issued in payment until a later date:

Dr.-Unamortized		
Organization Costs	\$620	
Cr.-Other Accounts Payable		\$620

b) When any part of the entire amount of the Unamortized Organization Cost is written off:

Dr.-Miscellaneous		
Operating Expenses	\$12	
Cr.-Unamortized Organization		
Costs		\$12

Detailed Transactions

Debit:

a) With the costs of organization and original bookkeeping supplies purchased at the time the credit union is organized.

Credit:

a) With the portion of the balance of this account when written off to expense.

Deferred Charges-Commitment Fees Paid in Connection with the Acquisition of Borrowed Funds

Commitment fees paid in connection with the acquisition of borrowed funds should be deferred. The treatment of the fees paid depends on the type of contract entered into and whether or not the commitment is exercised:

- If the commitment expires unexercised, the commitment fees paid should be expensed in "Unexercised Commitment Fees."
- If the borrowed funds will be repaid as a term loan, the commitment fees should be transferred to "Notes Payable-Commitment Fees" and amortized as interest on borrowed funds according to the interest method. See "Net Origination Fees (Costs)-Real Estate Loans Over 12 Years" for a detailed discussion of the interest method.
- If the credit union borrows funds under a revolving line of credit, the commitment fees should be amortized based on the straight-line method over the life of the contract. "Commitment Fees" should be used to record this expense.
- If the credit union pays all borrowings under a revolving line of credit and cannot reborrow under the contract, any unamortized fees should be expensed to "Commitment Fees."
- If the revolving line of credit contains an option to convert to a term loan, the fees should be amortized based on the straight-line method over the combined life of the line of credit and term loan. If the option is not exercised and all

borrowings are extinguished, any unamortized fees should be expensed.

- If the option to convert to a term loan is exercised, any unamortized fees would be transferred to “Notes Payable-Commitment Fees” and amortized as interest on borrowed funds using the interest method.

Illustrative Entries

- a) To defer commitment fees paid in connection with borrowed funds:

Dr.-Deferred Charges- Commitment Fees Paid in Connection With the Acquisition Of Borrowed Funds	\$2,200	
Cr.-Cash		\$2,200

- b) If the commitment expires unexercised:

Dr.-Unexercised Commitment Fees	\$2,200	
Cr.-Deferred Charges- Commitment Fees Paid in Connection With the Acquisition Of Borrowed Funds		\$2,200

- c) If the borrowed funds will be repaid as a term loan, related commitment fees should be periodically expensed as follows:

Dr.-Commitment Fees on Borrowed Money	\$200	
Cr.-Deferred Charges- Commitment Fees Paid in Connection With the Acquisition Of Borrowed Funds		\$200

- d) If the credit union borrows funds under a revolving line of credit and properly amortizes commitment fees using the straight-line method over the life of the contract:

Dr.-Commitment Fees on Borrowed Money	\$220	
Cr.-Deferred Charges- Commitment Fees Paid in Connection With the Acquisition Of Borrowed Funds		\$220

- e) If the credit union pays all borrowings under a revolving line of credit and cannot re-borrow under the contract, all related unamortized commitment fees should be expensed:

Dr.-Commitment Fees on Borrowed Money	\$2,000	
Cr.-Deferred Charges- Commitment Fees Paid in Connection With the Acquisition Of Borrowed Funds		\$2,000

- f) If the revolving line of credit contains an option to convert to a term loan, the fees should be amortized over the combined life of the line of credit and the term loan as in d. above. If the option is not exercised, any unamortized fees should be expensed as in e. above:

- g) If the option to convert to a term loan is exercised, deferred fees should be expensed as in c. above.

Detailed Transactions

Debit:

- a) With the amount of deferred commitment fees paid.

Credit:

- a) With the amount of the periodic amortization of commitment fees or write-off of unamortized commitment fees.

Deferred Pension Cost

This account consists of unamortized past service pension costs that are amortized for a period of not

less than 10 nor more than 40 years. A full discussion of pension plan accounting is beyond the scope of this Manual – seek the assistance of an independent accountant who can inform you concerning accounting rules under generally accepted accounting principles.

Other Prepaid Expenses and Deferred Charges

This account reflects the unamortized balance of prepaid expenses and deferred charges not specifically listed elsewhere which are to be allocated to subsequent operations.

This account is for use by credit unions following the modified cash basis of accounting as well as those following the accrual basis. Each credit union should determine the particular expense charges to be recorded in this account in order to spread the cost over the periods to be benefited. Examples of items which may be recorded as prepaid expenses or deferred charges include stationery and supplies, association fees, advances for accounting services, and the NCUA operating fee.

Subsidiary ledgers should be maintained for each prepaid and deferred expense reflecting the initial charge to the account, date, complete description of the expense, periodic amortization credits and balance remaining on each item. These subsidiary ledgers should be balanced to the General Ledger control account each month.

Entries in the Journal and Cash Record

Entries to establish prepaid expenses and deferred charges in this account should be recorded as "Miscellaneous-Debit". Entries to write off prepaid expenses and deferred charges should be credited to this account as a "Miscellaneous Credit; the offsetting debit to expense should be posted to "Operating Expenses (Control)", and numerical identification of the detailed expense account should be shown as "Account No."

Illustrative Entries

- a) To establish a prepaid expense or deferred charge for allocation to future period costs; e.g., if

stationery and supplies are purchased which will last for 3 years:

Dr.-Other Prepaid		
Expenses and		
Deferred Charges	\$360	
Cr.-Cash		\$360

- b) To prorate the expense applicable to each quarter year:

Dr.-Stationery and		
Supplies	\$30	
Cr.-Other Prepaid		
Expenses and		
Deferred Charges		\$30

Note: The cost recorded as other prepaid or deferred expenses may be prorated monthly, quarterly, or at the end of a regular share account dividend period.

Detailed Transactions

Debit:

- a) With charges paid or incurred which are to be allocated to future periods.

Credit:

- a) With the write-off of prepaid expenses and deferred charges to expense over the periods to which they apply.

INVESTMENTS IN AND LOANS TO CREDIT UNION SERVICE ORGANIZATIONS

These accounts are used to record investments in and loans to credit union service organizations (CUSOS) in accordance with Section 107(7)(I) and 107(5)(D), respectively, of the Federal Credit Union Act and Part 712 of the NCUA Rules and Regulations.

LOANS TO OTHER CREDIT UNIONS

This account should be used to record outstanding principal balances of all loans made to other credit unions in accordance with Section 107(7)(c) of the Federal Credit Union Act and Part 703 of NCUA's Rules and Regulations. The maximum investment in loans to other credit unions shall not exceed 25% of the investing credit union's paid in and unimpaired capital and surplus. A properly executed note of the borrowing credit union should be obtained at the time that the loan is made.

Entries in Journal and Cash Record

Debit this account as a "Miscellaneous-Debit" with the amount of new and renewal loans made to other credit unions. Credit this account as a "Miscellaneous-Credit" with the amounts received in part or in full payment of loans made to other credit unions; also, with the unpaid balance of such loans upon renewal.

Posting to General Ledger

Each entry involving this account is posted individually to the General Ledger as "Miscellaneous" in the Journal and Cash Record.

The names and addresses of credit unions to which loans are made should be clearly shown in "Explanatory Remarks" area of the General Ledger account. It is also desirable to show the terms of the loan, such as rate of interest and maturity date.

Subsidiary of General Ledger Account

When loans are made to two or more credit unions, it is recommended that subsidiary records be maintained to clearly identify transactions with each credit union. If subsidiary records are maintained, it should not be necessary to complete the "Explanatory Remarks" column of the General Ledger account.

Illustrative Entries

a) When a loan is made to another credit union, and a check is issued:

Dr.-Loans to Other Credit Unions	\$1,000	
Cr.-Cash		\$1,000

b) When the above loan to another credit union is repaid with interest:

Dr.-Cash	\$1,010	
Cr.-Loans to Other Credit Unions		\$1,000
Cr.-Income from Other Investments		10

c) When a loan to another credit union is partially paid and renewed at maturity of the loan:

Dr.-Cash	\$410	
Dr.-Loans to Other Credit Unions	600	
Cr.-Loans to Other Credit Unions		\$1,000
Cr.-Income from Other Investments		10

Detailed Transactions

Debit:

a) With principal amounts of loans made to other credit unions.

Credit:

a) With amounts of principal repayments received on loans to other credit unions.

ACCRUAL BASIS OF ACCOUNTING

Credit unions using the accrual basis should record income earned from these investments on a monthly basis, or alternatively, at least quarterly or at the end of each regular share dividend account period. The accrued income should be recorded by a debit to "Accrued Income from Investments". The entry to record interest received should consist of a debit to "Cash" and as a credit to "Accrued Income from Investments".

INSURANCE PREMIUM STABILIZATION RESERVE

This account may be used by those credit unions participating in risk rating plans for loan protection and life savings insurance. The account should reflect funds advanced to the insurance company or funds retained by the insurance company which would have otherwise been returned to the credit union as a dividend or refund of premium paid. The funds advanced to, or withheld by the insurance company, serve as a reserve from which claims will be paid when previous claims have exceeded a stated portion of premium payments.

Entries in the Journal and Cash Record

All entries affecting this account should be recorded in the "Miscellaneous" column of the Journal and Cash Record.

Illustrative Entries

a) To record funds advanced to the insurance company in accordance with the risk rating plan contractual agreement:

Dr.-Insurance Premium		
Stabilization Reserve	\$1,000	
Cr.-Cash		\$1,000

b) To record a premium refund retained by the insurance company as a reserve for payment of claims:

Dr.-Insurance Premium		
Stabilization Reserve	\$500	
Cr.-Members' Insurance		\$500

For another method of recording this transaction refer to the "Deferred Credit Insurance Premium Stabilization Reserve" account in Section 400 Liabilities.

c) When the credit union is notified of excess claims paid by this insurance company and charged to the reserve:

Dr.-Members' Insurance	\$200	
Cr.-Insurance Premium		
Stabilization Reserve		\$200

Detailed Transactions

Debit:

a) With funds advanced to, or withheld from premium refunds by the insurance company.

Credit:

a) When notified by the insurance company of excess claims paid and charged to the account.

ACCRUED INCOME

Accrued Income on NCUSIF Investment

This account should be used to record the redistribution (dividends) of NCUSIF equity to participating credit unions by the NCUA Board as necessary to reduce the NCUSIF to its normal operating level.

Note: Accruals should be recorded only after the NCUA Board declares a redistribution from the NCUSIF, not in anticipation of a declaration of dividends.

Illustrative Entries

a) To record a declared redistribution from the NCUSIF:

Dr.-Accrued Income on		
NCUSIF Investment	\$450	
Cr.-Income from Investment in		
NCUSIF		\$450

Reference Rules and Regulations, Part 741.4.

Other Accrued Income

This account is used to record earned income not otherwise provided for in other accrued income accounts. This account might be used for rental

income, income due from the sale of money orders, travelers checks, or other reimbursements for costs incurred for services that have been furnished to members.

This account should include the total amount of interest earned but not received for these miscellaneous items. This can be accomplished by debiting "Other Accrued Income" and crediting "Other Miscellaneous Operating Income" at the end of the month, quarter, or regular share account dividend period. On the following day (i.e., first day of the month), the accrual entry should be reversed by debiting "Other Miscellaneous Operating Income" and crediting "Other Accrued Income". As a preferable alternative to reversing this accrual entry, interest collected may be credited directly to "Other Accrued Income" until its balance reaches zero. Once this occurs, subsequent amounts received should be credited to "Other Miscellaneous Operating Income".

The illustrative entries and detailed transactions for this account will be similar to those previously outlined for "Accrued Income on Investments". Therefore, transactions and entries will not be repeated here.

OTHER ASSETS

This account is used to record transactions involving assets for which there is no specific asset account provided. Among the items which may be included in this account are:

- a) Deposits paid on safe deposit box keys or utility services.
- b) Collection and court costs advanced on loans.
- c) Property owned by the credit union for which no other account is provided.

Posting to General Ledger

Entries to this account are posted individually from the "Miscellaneous" in the Journal and Cash Record. Each entry should be adequately explained in the "Explanatory Remarks" area of the General Ledger account.

Detailed Transactions

Debit:

- a) With other assets to be entered in this account.

Credit:

- a) With amounts recorded in this account when collected or otherwise disposed of.