Chapter 25

CREDIT UNION SERVICE ORGANIZATIONS

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CUSO Review Objectives

- Determine that the credit union's investment in and loans to a CUSO comply with Part 712 of *NCUA Rules and Regulations*
- Determine that the CUSO engages in permissible activities or services
- Determine the degree of risk the CUSO poses to the affiliated credit union
- Determine the ongoing feasibility of the CUSO
- Determine the CUSO is in compliance with the Privacy Act

Associated Risks

- Interest rate risk - improper pricing of products and services constitutes the leading cause of interest rate risk;
- Liquidity risk - improper pricing and poorly timed duration can cause liquidity risk;
- Reputation risk – poor decisions by the CUSO can reflect poorly on the member and third-party perception of the credit union;
- Strategic risk - ineffective planning of the products, services, and pricing policies can result in strategic risk;
- Credit risk - credit risk can occur when the CUSO fails to meet its obligations;
- Transaction risk – improper transaction processing and controls of share account types and processing failures can cause other risks (e.g., interest rate risk, liquidity risk); and
- Compliance risk – inadequate or ineffective compliance policies regarding account disclosures for applicable consumer compliance regulations can result in loss exposure.

Specific activities undertaken by the CUSO and the amount of funds invested in or loaned to the credit union may magnify these risks. Strategic risk applies in all CUSOs, because if the board has not properly planned, and the CUSO has taken on excessive risk, losses can damage the credit union's profitability, net worth, and reputation. Transaction, credit, and liquidity risks can affect the credit union's ability to continue to offer the services (provided by the CUSO) to its members. These can also negatively impact the financial condition and reputation of the credit union.

Overview

A credit union service organization (CUSO) is a corporation, limited liability corporation, or limited partnership that provides services primarily to credit unions or members of affiliated credit unions. Part 712 of NCUA's Rules and Regulations authorizes federal credit unions to invest up to one percent of unimpaired capital and surplus in CUSOs and/or to loan up to an aggregate of one percent of unimpaired capital and surplus to CUSOs.

A CUSO's organizational requirements, i.e., corporation (established and maintained under federal or state law), limited liability corporation, or limited partnership (an FCU may only participate in a limited partnership as a limited partner), limit the risk of loss to the affiliated credit unions to each credit union's loan and/or investment in the CUSO. However, the loss of a CUSO service could affect the operations and financial condition of affiliated credit unions beyond their one percent investment in and/or one percent loan to the CUSO.

CUSOs exist as separate legal entities chartered under state law (except that a corporation may also be established under relevant federal law). NCUA neither charters nor insures CUSOs; therefore, they are not subject to NCUA regulations and credit union-type examinations. CUSOs must comply with applicable state laws, including state licensing and regulated activities' laws.

NCUA does have contractual rights of "complete access to any books and records of the CUSO and the ability to review CUSO internal controls . . ." For this reason, the term "CUSO review" appears throughout this chapter. NCUA performs CUSO reviews when safety and soundness concerns to affiliated credit unions may exist. Examiners perform CUSO reviews in a consensual manner in cooperation with CUSO management when NCUA deems the CUSO may pose an undue risk to the National Credit Union Share Insurance Fund (NCUSIF).

In instances when disputes arise between the examiner and a CUSO over access to books and records or problem resolution, the examiner should look to the supervisory examiner and regional policy for guidance on resolution. Examiners should take a professional, reasonable approach with CUSO management and consult their supervisors if they encounter circumstances that they cannot cooperatively resolve with CUSO management. Examiners should tailor review procedures according to the size, complexity, and business of the CUSO.

Services

Unless safety and soundness concerns exist, an FCU may invest in, loan to, or contract with CUSOs sufficiently bonded or insured for their specific operations. The CUSO must engage in the preapproved activities and services related to the routine daily operations of credit unions.

The *NCUA Rules and Regulations* speifies and categorizes all services that CUSOs may perform. Categories of permissible services include: checking and currency services; clerical, professional, and management services; consumer mortgage loan origination; electronic transaction services; financial counseling services; fixed asset services; insurance brokerage or agency; leasing; loan support services; record retention, security, and disaster recovery services; securities brokerage services; shared credit union branch (service center) operations; student loan origination; travel agency services; trust and trust-related services; real estate brokerage services; and CUSO investments in non-CUSO providers. (The listings under the broad categories shown in §712.5 serve illustrative purposes and are not an exclusive or exhaustive list of permissible activities.)

The credit union must ensure that the services provided by the CUSO meet the requirements of the Privacy Act. The contractual agreement between the CUSO and the credit union should specifically limit access and distribution of members' records to accomplish compliance under the Privacy Act. The credit union must pay particular attention to the CUSO's privacy policies and procedures to determine compliance with all applicable laws and regulations on disclosure of members' information. Information that the credit union shares with the CUSO should also comply with privacy regulations.

The cyber financial services that CUSOs may provide (under the electronic transaction services) to credit unions and their members include electronic delivery of any permissible CUSO service and electronic delivery of any permissible credit union service.

An FCU that wants to invest in or loan to a CUSO that offers an unpreapproved activity or service must seek an advisory opinion from NCUA's Office of General Counsel regarding whether the proposed activity falls within one of the authorized categories without filing a petition to amend the regulation. If General Counsel determines that an authorized category does not cover the activity in question, the credit union must petition the NCUA Board to amend the regulation. The request for petition must comply with the following:

- Request NCUA Board approval and include an explanation and documentation of the activity or service and how that activity or service is associated with routine credit union operations;
- Submit request jointly to regional office and to the Secretary of the NCUA Board.

CUSO Reviews

Examiners may consider recommending a CUSO review if, during an examination of an affiliated credit union, the following questions arose:

- Is the CUSO operation adversely affecting the financial condition and operation of the credit union?
- Does the financial condition of the CUSO significantly affect the operations of a credit union or group of credit unions that depend on the CUSO's services?
- Is the credit union taking appropriate steps to ensure that the CUSO operates as a separate entity thus limiting the credit union's risk exposure?
- Is the credit union board of directors ensuring the CUSO's separate entity status?

- Is credit union or CUSO management involved in any conflicts of interest as described in §712.8 of the regulation?

- Are the services offered permissible (see §712.5)?

- Did the affiliated credit union obtain a written agreement from the CUSO, before investing in or lending to the CUSO, that provides for compliance with §712.3(d)?

- Does the CUSO obtain an annual certified public accountant (CPA) audit?

- Did the CPA note substantive operational or financial problems?

Purpose

Examiners perform a CUSO review to determine the degree of risk the CUSO poses to affiliated credit unions. Following are several steps that may assist the examiner in determining such risk:

- Assessing the financial condition of the CUSO;
- Verifying the accuracy of the financial statements;
- Assessing the adequacy of controls;
- Determining the viability of operations and service to the member credit unions; and
- Confirming compliance with applicable laws and regulations.

Preparation

Before conducting a CUSO review, the examiner must understand the services offered, market trends and conditions, and service viability. The Reference section of this chapter contains reference sources that may familiarize the examiners with acceptable practices for a specific service offered. As examiners become familiar with a CUSO's internal operations, the examiner may need to update or modify the review procedures to achieve a more effective review. Examiners may consider the following when preparing for a CUSO review:

- Initial Contact. Once the region determines that the potential risk posed by the CUSO warrants a review and obtains the necessary regional approval, an NCUA regional representative should contact the president or chairman of the CUSO to discuss the purpose of the upcoming review, schedule a mutually agreeable date, and request basic financial and audit information needed for the review.

After agreeing upon the date, the examiner may draft a letter to the CUSO confirming the date of the review and providing a list of items needed for the review.

- State Supervisory Authority (SSA). When NCUA decides to proceed with a review of a CUSO that also serves state-chartered credit unions, an NCUA regional representative contacts the SSA to (1) convey its concerns, (2) request information that the state may have regarding the operations of the CUSO, and (3) invite the SSA's participation on the CUSO review. SSAs often have special CUSO review reports, which the examiner may benefit from reading before proceeding with a CUSO review. To avoid duplication of effort and unnecessary regulatory burden, NCUA should use information provided by the SSAs' CUSO review reports whenever possible.

- Team. Choosing qualified team members is important. For example, examiners that have accounting, finance, outside audit experience or expertise in the areas of the CUSO's operation will benefit the CUSO team.

- Review. The examiner-in-charge develops a review program emphasizing areas of immediate concern as well as covering general operations, financial condition, management, and corporate separateness (see Appendix 25A for a sample CUSO review.)

  The extent of the tests performed vary relative to the nature of the services offered and risks involved. However, the following steps may assist the examiner in becoming familiar with the CUSO's operation and developing an initial review:

  - Obtain knowledge of the industry in which the CUSO operates;
  - Obtain general information about the CUSO's business (e.g., requesting an organization chart, business plan);
  - Review the field file of an affiliated credit union for any prior information regarding CUSO policies;
  - Review prior CUSO examination and audit results;

- Determine the existence of related party transactions;
- Determine the need for outside specialists (e.g., information systems specialist);
- Develop a review strategy;
- Write a review program that places primary emphasis upon weaknesses noted in reviewing the CUSO's operations, facilities, and financial condition; and
- Request a tour of the CUSO facilities.

The extent of operational tests performed for the CUSO review vary relative to the services offered by the CUSO (e.g., data processing, share draft clearings, leasing, etc.). Therefore, the examiner should exercise flexibility and innovation in preparing and modifying the review to the services and operations of the CUSO.

Review of Operations and Management

When performing an onsite review of the CUSO's operations, the examiner may inquire about the CUSO's managerial controls and about the CUSO's working arrangements with leagues or trade associations. The following guidelines may assist the examiner's review of operations and management:

- Management. The examiner may arrange to review the CUSO's policies, procedures, budgets, business plan, goals and objectives, reporting processes, articles of incorporation, and bylaws. The examiner may discuss with management the nature and extent of managerial planning, the overall reasonableness of the business plan, and budgetary projections.

- Business Plan. Good business planning involves management's development of a written business plan before the organization begins doing business. A CUSO's business plan should, at a minimum, include (1) a statement of goals (including profitability goals) and objectives; (2) policies, procedures, and timeframes for achieving the goals and objectives; (3) budget projections demonstrating management's efforts to meet profitability and capitalization goals, and achieve (and maintain) self-sufficiency; and (4) monitoring techniques to inform management of the operation's status. Management should revise and update the business plan as necessary to keep it current. (A CUSO's well-developed and maintained business plan provides affiliated credit unions a valuable resource for making decisions about permissible investment and lending decisions.)

- Managerial Personnel. An onsite CUSO review provides the examiner an opportunity to observe and ascertain management's ability to effectively direct and control the CUSO's operations. As part of the review of key personnel, the examiner may find it helpful to request resumes and employee evaluations and to detail, in the working papers, background information of key management officials. (State laws may affect disclosure of staff evaluations.) The necessary experience and education for key personnel depends on the types and levels of service the CUSO offers. NCUA's CUSO review report should note observed managerial weaknesses.

- Minutes. The examiner reviews board minutes for content, decisions, and required frequency of meetings according to the CUSO's bylaws. If available, the examiner may also request other minutes, including those of user/client meetings, special meetings, and executive committee meetings.

- Investment and Loan Documents. The examiner reviews investment and loan documents and CUSO agreements with affiliated credit unions.

Review of Services

The examiner should determine that the CUSO follows the regulation in performing permissible services and serving primarily credit unions or their members.

The CUSO's quality of services provides information about the ongoing feasibility of the CUSO. If available, membership surveys, complaint departments, and third-party studies can assist the examiner in assessing the quality of services.

Financial Condition

Examiners evaluate the CUSO's financial condition to (1) determine its ability to meet its goals, objectives, and financial projections; (2) analyze its prospects for future success; and (3) assess the risk to affiliated credit unions. Financial trends for a start-up operation are often misleading; therefore, when calculating trends, the examiner must differentiate between start-up CUSOs and those with several years' experience (e.g., cash flow projections, since CUSOs expense start-up costs as they incur the costs.) The following areas may assist examiners in the review of financial condition:

- Trend Analysis. The financial analysis of a CUSO resembles that performed during credit union examinations using the Financial History and Key Ratios workpapers; however, some ratios used to evaluate CUSOs differ from those used for credit unions (see Appendix 25B for suggested key CUSO financial ratios.) To better understand the CUSO's trends and ratios, examiners may request at least three years' financial data. Comparative ratios (both over the prior three years and to industry averages) assist the examiner in determining the reasonableness of the CUSO's current financial condition. Both Dun & Bradstreet (www.dnb.com) and Robert Morris Associates (www.rma.org) publish industry averages.

- Profitability. Because of tax consequences, CUSO profitability objectives may differ from those of credit unions; however, CUSOs still require sufficient cash flow to meet their objectives. Examiners analyze earnings to ensure their sufficiency to pay for services offered, while achieving profitability and capital goals.

  Examiners should know that in non asset-based CUSOs many expenses incurred are a function of sales and, therefore, directly relate to sales. To ensure meaningful ratios and trends in these credit unions, examiners should compare expenses to sales.

- Cash Flow. Profitable corporations, including CUSOs, do not always have positive cash flow. This is more often true in the initial or start-up stages, but can also result from mismanagement. Conversely, since CUSOs hope to reduce taxes by minimizing net income without affecting cash flow, CUSOs may not show a profit, but have positive cash flow.

  To analyze cash flow, examiners may request cash flow statements. If the CUSO does not prepare cash flow statements and cash flow appears to be a problem, examiners should analyze the cash flow position to ensure the CUSO has sufficient cash flow to maintain normal operations. Depending on its severity, negative cash flow may require the examiner to expand review, discuss the situation with CUSO management, and develop (with CUSO management) a plan to reverse the trend.

- Taxes. As taxable entities, CUSOs should adjust their projections for their tax liabilities. During the review, the examiner may request a copy of the CUSO's IRS filings (and documentation of other local, state, or municipal tax liabilities) for review of proper payment and inclusion in the supporting work papers.

Accounting Audit

Determining the extent of the review of the CUSO's accounting and audit requires that examiners use judgment in the following areas:

- General Ledger. The examiner requests for review the audit report, notes to the audit report, engagement letter, report of reportable conditions (if available), and other correspondence before determining the extent of the general ledger review. If the examiners do not question the CPA's competence and independence, they may place greater reliance on the CPA's work.

  The examiner may decide to rely on the CPA's work and not perform a comprehensive general ledger review. In these instances, examiners may limit their general ledger reviews to the areas of concern. For example, the examiner may choose to review only the CUSO's tax filings and aging of receivables and payables, or only the appropriateness of classification of accounting information (e.g., expenses improperly capitalized or income improperly recognized.) Examiners may want to pay particular attention to the collectibility of accounts receivable. (If material uncollectible receivables exist, NCUA may require affiliated credit unions to reserve for their investments in and loans to CUSOs.)

- Audit. The examiner reviews the most recent CPA opinion audit report, notes to the audit report, engagement letter, report of reportable conditions (if available) and other correspondence with the CPA. When examiners determine that the CPA is competent and independent, they may find a review of the workpapers unnecessary.

When examiners believe reviewing the correlating audit workpapers is necessary, they may request permission from the CUSO to review the workpapers and ask the CUSO to make necessary arrangements with the CPA firm. Review of audit workpapers often provides meaningful information they cannot obtain by simply reviewing the audit report (e.g., the CPA's assessment of the CUSO's internal controls and a statement regarding ongoing concern.)

Examiners should also confirm that the CUSO follows GAAP, as required by §712.3(c) and §712.3(d)(1) of the regulation.

Controls

The examiner's onsite CUSO review may include assessing the adequacy of internal controls necessary for the CUSO's business. Likewise, if the CUSO has an internal audit function, the examiner may arrange to review the audit scope and procedures.

Data Processing

During an onsite review, the examiner may arrange to review the CUSO's information processing system including related controls and the disaster recovery plan.

Privacy of Consumer Financial Information

Part 716 requires that credit unions provide notice to their members and consumers regarding the credit union's privacy policies and practices for information provided to affiliated and nonaffiliated third parties. The rule describes the conditions under which a credit union may disclose nonpublic information about consumers to nonaffiliated third parties. Finally, Part 716 provides for opting out, whereby consumers may prevent a credit union from disclosing nonpublic information to most nonaffiliated third parties.

An affiliate is a company that a credit union or a group of credit unions controls. Examples include the following:

- For federally chartered credit unions, a credit union service organization (CUSO) controlled by the credit union would constitute the only affiliate. NCUA will presume a credit union has a controlling influence over the management or policies of a CUSO, if the CUSO is 67 percent owned by that credit union or by that credit union and other credit unions; and

- For federally insured state credit unions, an affiliate would include a CUSO or another company controlled by the credit union.

A nonaffiliated third party is any person except:

- The credit union's affiliate; or

- A person employed jointly by the credit union and any company that is not the credit union's affiliate.

Maintaining Legal Separation

§712.4 of the Rules and Regulations requires that a credit union investing in or loaning to a CUSO take reasonable steps to ensure that a court would not "pierce the corporate veil" and hold it liable for the obligations of the CUSO. This can happen when (1) the corporation (the CUSO) has insufficient assets to satisfy its debts, and (2) a parent entity (the credit union) so closely identifies with the corporation that justice requires holding the parent liable for those debts. The factors courts look to in deciding whether to impose liability on the credit union include inadequate capitalization of the CUSO, lack of separate CUSO identity, common boards of directors and employees, control of the credit union over the CUSO, and lack of separate books and records. The following help determine these factors:

- Whether CUSOs follow the corporate forms (holding meetings, taking minutes, etc.);

- Whether the CUSO's management is distinct from the credit union's;

- Whether the CUSO's operations are distinct from the credit union's; and

- Whether the CUSO has adequate capitalization for its type of business.

There is usually no single controlling component that the courts use in determining whether to pierce the corporate veil

§712.4(b) requires a written attorney's opinion stating that the CUSO's structure as a separate legal entity limits the credit union's potential exposure to no more than the loss of funds invested in and/or loaned to the CUSO. The legal opinion should address the factors specified above. Affiliated credit unions should obtain a new legal opinion if the CUSO restructures its organization or if the operations of the CUSO raise potential credit union liability issues.

The examiner should review the following items, which evidence that the CUSO and the credit union function as separate entities. However, the examiner may decide to forgo this review if through the scoping process, the examiner has determined that the prior examiner reviewed them, and no changes have subsequently occurred, or the annual CPA audit of the CUSO indicates no material problems exist.

- Articles of incorporation or partnership agreement filed with the state;

- Written bylaws;

- Minutes of the first meeting of shareholders or partners or a unanimous consent of the shareholders or partners electing the board of directors;

- Minutes of the first meeting of directors or a unanimous consent of the directors electing officers and authorizing the issuance of the shares and adoption of the bylaws;

- Review of stock certificates;

- Proof of capitalization and minimally adequate capital to support the business plan; and

- A letter from an attorney licensed to practice in the state where the CUSO principally operates opining that the CUSO's structure limits the liability of the credit union to the investment in and/or loan to the CUSO.

The following can aid the examiner in determining whether the CUSO operates as a separate entity with sufficient financial resources of its own and necessary distinction in management and operations:

- Each ensures against intermingling of its respective business transactions, accounts, and records (e.g., appropriate management agreements, equipment leases, or real estate leases support payments made by the CUSO to the credit union for rent, shared employee costs, etc.);

- Each observes the formalities of its separate corporate procedures (e.g., each holds regular separate board meetings, each has separate management);

- Each is adequately financed as a separate unit in the light of normal obligations reasonably foreseeable in a business of its size and character (e.g., each has adequate capitalization in relation to its business plan);

- The public sees each as a separate enterprise (e.g., space that a CUSO rents in the credit union should be separated from the credit union operations with a separate mailing address and telephone number, if possible);

- The credit union does not dominate the CUSO to the extent that it or the members treat the CUSO as a department of the credit union; and

- Except if the CUSO has a loan guaranteed by the credit union, all borrowing by the CUSO indicates that the credit union is not liable (i.e., the credit union does not provide guarantees to the CUSO which could cause the credit union to incur liability in excess of the permitted investment limitation in the regulation).

Additionally, during onsite reviews, the examiner may arrange to review the CUSO's compliance with all other applicable regulations, such as consumer regulations and state laws.

Finally, NCUA encourages CUSOs to maintain appropriate levels of liability insurance and bonding. Management should periodically review coverage to ensure adequate protection. In reviewing the adequacy of bond coverage, examiners use their professional judgment considering the CUSO's type (e.g., shared branching CUSOs would require similar coverage as credit unions), state law requirements, industry standards, and insurance company recommendations.

Impairment Assessment

Under GAAP, an "other -than-temporary" impairment in the credit union's CUSO investment (assuming a cost method CUSO investment), requires a write down of the asset through the income statement to a new cost basis. This new cost basis cannot be subsequently written up for a recovery of value. The credit union should consult its independent accountant if it suspects an "other-than-temporary" impairment and provide the examiner with the independent accountant's assessment as it relates to GAAP. Examiners should watch for the following "red flags," which may indicate possible "other-than-temporary" impairment:

- Material negative cash flow resulting in an inability to meet obligations;
- Continual operating losses resulting in, or leading to, a deficit in retained earnings; or
- Piercing of the corporate veil.

Report Format

The final report drafted by the examiner may include the following work papers:

- Open section:
  - Narrative giving overall results of the CUSO review;
  - Findings;

  - Conclusions and Recommendations; and
  - Financial data and trends.
- Closed section:
  - Confidential section;
  - Extent of CUSO risk-focused review (at examiner's discretion, they could include this in the open section); and
  - Any other work papers needed to support the examiner's conclusions.

Supervision

When examiners discover material problems that may adversely affect affiliated credit unions, the regional director may arrange with the CUSO for supervision and follow-up measures commensurate with the problems cited at the last contact. Supervision normally consists of reviewing problem areas and weaknesses noted during the most recent review. This should not imply that NCUA has the same supervision authority over CUSOs as it has over credit unions. As with CUSO reviews, supervision contacts are performed on a consensual basis through the affiliated credit unions.

Supervision responsibilities vary depending on the equity and debt structure of the CUSO. If the CUSO is a direct subsidiary of a credit union or if all affiliated credit unions are in the same supervisory examiner's group, the supervision responsibilities logically would remain with the supervisory examiner responsible for the credit union. In other cases, however, the regional director or associate regional director for programs assigns supervision responsibilities.

Suggested Procedures

In addition to those already discussed, the following are suggested procedures for performing a CUSO review once regional management has approved the review:

- At the close of the review, the examiners meet with the officials and key management (exit conference) providing them with a draft copy of the open section of the report (clearly labeled DRAFT). The examiner invites the SSA to attend exit conferences of CUSOs that also serve state-chartered credit unions;

- The examiner submits to the region's Division of Supervision:

  - The CUSO review report;
  - All supporting work papers (including financial statements, documentation specifying extent of the review, financial data and trends, and a listing of all affiliated credit unions); and
  - A final letter to the CUSO briefly describing the review procedures, conveying the results and findings of the review, and requesting a written response to the recommendations and findings;

- The regional office reviews the CUSO review report and letter for quality control and submits the letter to the regional director for approval;

- When the CUSO has state-chartered credit union investors or affiliated credit unions, the regional director furnishes a copy of the CUSO review report to the SSA for comment before mailing the open section to the CUSO. (Examiners should encourage CUSOs to hold the report in confidence knowing, however, that CUSOs have no obligation to confidentiality);

- Once approved and signed by the regional director, the regional office provides a copy of the CUSO review report to applicable supervisory examiners, noting that the content is confidential. (In the rare instance that a CUSO's risk to its owner credit unions requires a write-down of the asset, the regional director notifies the owner credit unions in writing); and

- When filing CUSO review reports, regional offices should cross reference these CUSO review reports to the examinations of the affiliated credit unions to give further credence to the fact that NCUA performs CUSO reviews to assess risk to insured credit unions.

References

- *NCUA Rules and Regulations* Part712
- *NCUA Rules and Regulations* Part 716
- Federal Financial Institutions Examination Council (FFIEC) manuals (www.ffiec.gov);

- Handbook of Accounting and Auditing (Warren, Gorham & Lamont) - available at local libraries and business schools (and possibly in the regional office);

- Generally Accepted Auditing Standards (GAAS);

- (Current Year) Miller GAAS Guide (for various checklists that can be modified for examinations) - available at local and business libraries (and possibly in the regional office);

- Finance textbooks which define and describe financial ratios - available at local and business libraries; and

- Robert Morris (www.rma.org) or Dun & Bradstreet (www.dnb.com) - available at local and business libraries.

SAMPLE CUSO REVIEW - APPENDIX 25A

CUSO Reviews are performed in a consensual manner in cooperation with the CUSO's management. This review is not a required form; rather, it is intended to be a guideline for examiners to complete as necessary.

The General CUSO Review applies to most CUSO operations. Specialized CUSO Reviews contain additional procedures that examiners may use to review CUSOs formed for a specific purpose.

CUSO General Review

Organization/Management

Review the articles of incorporation, bylaws, and mission statement _____

Review attorney's opinion stating that the CUSO has been structured as a separate legal entity (including any recommendations for strengthening the corporate veil) to limit the liability of affiliated credit unions' investment in and/or loans to CUSOs _____

Review the limited partnership agreement and inquire as to whether the CUSO is a limited partner _____

Inquire about the General Partner and the General Partner's relationship to affiliated credit unions if the CUSO is organized as a limited partnership _____

Review the documentation of the limited liability corporation and inquire as to whether this organizational structure is permitted by federal or state law _____

Inquire as to whether the limited liability corporation provides sufficient limits to the liability of affiliated credit unions' investment in and/or loans to CUSOs _____

Review whether the CUSO has funding guaranteed by affiliated credit unions _____

Inquire as to whether there are contingent liabilities of the CUSO that could directly affect affiliated credit unions _____

Review what steps have been taken to evidence to members, customers and third parties that the CUSO and affiliated credit unions have separate identities both in operation and management _____

Inquire whether CUSOs that offer non-deposit products (e.g., mutual funds, annuities, insurance products, etc.) have adopted policies and procedures to comply with NCUA Letter No. 150 _____

Inquire about management interlocks _____

Inquire about primary users of CUSO services (i.e., that CUSO primarily serves credit unions and/or membership of affiliated credit unions) ____

Review permissibility of activities and services ____

Review business plan (including feasibility of goals and objectives) ____

Request organizational chart and job descriptions for management and staff ____

Review qualifications and performance of management and officials ____

Review the CUSO's policies and procedures manual ____

Review the board and committee minutes ____

Review supporting documents for credit unions with loans to and/or investments in the CUSO ____

Request list of participating credit unions and other third parties (including leagues and trade associations) ____

Review CUSO's working arrangements with the league and trades ____

Review promotional materials and sample service agreements ____

Request information regarding member satisfaction with services offered:

- Review complaint department ____
- Review any member surveys performed ____
- Review any third party reviews ____

Request minutes of users' meetings (if any) ____

Review management's budgetary process ____

Review material contracts (e.g., management, data processing, vendors, leases) ____

Financial Condition

Review feasibility of budget in conjunction with business plan goals (including capitalization projections) ____

Review the statement of financial condition, statement of income, and statement of changes in financial position ____

Review operating fee agreements with participating credit unions for stable, reasonable, projected costs under various future operating environments ____

Review projections for operating and capital costs, review management's capital requirements goals for compliance with SEC capital requirements (where necessary) ____

Review the CUSO's cash flow analysis ____

Request information about CUSO's backup funding arrangements ____

Review CUSO's exposure resulting from its reliance on one or more credit unions ____

Compute key financial ratios (usually for past three years), analyze financial trends and ratios, and compare trends and ratios with industry averages ____

Accounting/Auditing
Perform general ledger review (as necessary):

- Reconcile financial statements to general ledger ____
- Reconcile major accounts to the subsidiary ledgers ____
- Review recent bank reconciliations ____
- Review major income and expense accounts ____
- Review the accounts receivable and accounts payable aging schedules ____
- Review the adjusting entries to payable and receivable accounts to and from member credit unions ____

Review valuation of assets and accuracy of financial statements ____

Review adequacy of allowance for doubtful accounts ____

Review notes to financial statements (e.g., for contingent liabilities and outstanding commitments) ____

Review CUSO structure for "second tier" CUSO and review functions ____

Review recent IRS tax filings and state and local tax filings ____

Review CPA audit report, the engagement letter, letter of reportable conditions, contingency letter (make inquiries through present date) and check for statement regarding ongoing concern ____

Review procedures for allocating operating costs and assessing monthly fees and charges to member credit unions ____

Review sample of billing statements to credit unions ____

Review auditor's verification of member credit unions' investment and loan balances ____

Internal Controls

Request internal auditor or audit committee procedures, work papers, and other supporting documentation (if applicable) ____

Review for proper segregation of duties, vacation policy, supervisor review process ____

Review access and password control procedures ____

Review CUSO's procedures for verifying credit union membership ____

Review CPA's assessment of CUSO's internal controls (if problems are noted) ____

Information Systems (IS) Processing

Review third party vendor IS audit (if available) ____

Review IS data security policies, procedures, and controls (e.g., limited access to the system) ____

Develop or review flow chart of IS system ____

Review reports generated and inquire about supervisory management levels responsible for reviewing the reports ____

Review disaster recovery program (if available) ____

Regulations/Legal

Inquire about outstanding or pending litigation and probability of loss ____

Review bond coverage and other insurance coverage for reasonableness and compliance with applicable state and federal requirements ____

Review CUSO's practices as to compliance of the services performed with applicable privacy laws and regulations ____

Review compliance with applicable consumer regulations ____

Review compliance with applicable state and federal regulations ____

Mortgage Services CUSO

Additional Mortgage Services CUSO Review

Organization and Management

Review the rate lock reports to ascertain if the CUSO is meeting commitments ____

Review HMDA reports (if applicable) ____

Request a list of appraisers used by CUSO ____

Financial Condition
Review current status (and future assumptions) of the mortgage pipeline and the promptness of processing loans ____

Inquire about the monthly minimum number of mortgage contracts for the CUSO to be profitable ____

Review how changes in mortgage interest rates impact the mortgage pipeline ____

Internal Controls
Review disbursement procedures ____

Regulations/Legal
Review compliance with consumer compliance regulations (Reg B, Z, C, Reg X, HMDA, RESPA, Fair lending) ____

Shared Branch CUSO

Additional Shared Branch CUSO Review

Financial Condition
Review cost trends (e.g., per transaction) ____

Review operational costs per transaction (e.g., increasing or decreasing) ____

If costs are increasing, inquire as to whether management has alternative programs planned (e.g., emphasis on ATMs to limit labor costs) ____

Accounting/Auditing
Perform general ledger review:

- Review accuracy of material adjusting journal entries ____
- Review appropriateness of the branch accounting procedures ____

Internal Controls
Review internal controls for completeness, adequacy, and consistency throughout the shared branch network ____

In the absence of an internal control function, review compensating controls (particularly in the cash area) ____

If on-site contacts are performed at CUSO branches:

- Review control of cash, money orders, travelers checks, and other negotiable instruments ____
- Review ATM and night depository procedures and controls ____
- Spot check teller cash reconcilements ____
- Inquire about tellers' use of bait money, responsibility for this

area, and frequency of bait money review ____
Review access and controls of passwords, keys, etc. ____
Inquire about controls to prevent staff from performing transactions on their own accounts and accounts of family members ____
Review procedures to verify credit union membership ____
Review procedures to safeguard release of information about credit union members ____
Inquire about backup systems, procedures, and authorization for member transactions when the IS is off line ____

Lending (for service centers that perform lending services)
Review the extent of the CUSO's lending services ____

Review CUSO's loan application approval process for compliance with individual credit union's lending policies ____

Review membership controls, verifications, disbursement procedures ____

Review a sample of contracts with various credit unions involved in the lending program ____

Review consumer regulation compliance procedures ____

Review compliance with terms and conditions of the contract ____

Information Systems (IS) Processing
Review IS contracts, controls, and adequacy of output information ____

Regulations/Legal
Review compliance with:

Currency and foreign transactions ____
Posting of NCUA and/or other applicable insurance ____
Member confidentiality ____

Information Systems Processing CUSO

Additional Information Systems (IS) Processing Review

(Refer also to Information Systems and Technology chapter for guidance regarding information systems' processing)

Financial Condition
Review CUSO's analysis of each cost center or branch (if applicable) including the profitability of each segment ____

Review at least one actual service contract for each type of service arrangement (e.g., on-line, in-house, disaster recovery) ____

Review contract expiration dates of institutions using the IS processing system ____

Review the contracts' expiration date schedules for impact of potential nonrenewal of contracts ____

Internal Controls

Review internal controls in the computer operations area ____

Review operational procedures for adherence to the CUSO's formal policies ____

Review disaster recovery procedures including testing schedule to ensure that backup procedures remain adequate and computer service to credit unions will not be interrupted in case of disaster ____

Review access to CUSO computer operations (e.g., limited to authorized personnel) ____

Review methods used to confirm transactions ____

Information Systems (IS) Processing

Request copy of the most recent third party review opinion and review management's response to weaknesses noted in the report ____

Review controls pertaining to access, passwords, keys, etc. ____

Review controls to prevent staff from performing transactions on their own accounts or family members' accounts ____

Review security logs for possible security breach attempts ____

Review procedures safeguarding release of information ____

Review intrusion detection procedures ____

Review backup systems and procedures ____

Inquire whether backup site is on a different grid from main office ____

Inquire about anticipated downtime (time needed to transfer major records to backup system) ____

Review results of the most recent test of the backup system ____

Regulations/Legal

Review compliance with confidentiality of credit union members' data ____

Auto Leasing CUSO

Additional Auto Leasing CUSO Review

Internal Controls
Review operational policies and procedures including purchase of cars, establishment of capital cost amounts and residual values ____

Regulations/Legal
Review that CUSO's contingent liability insurance policy contains a specific endorsement for leasing ____

Review insurance contracts that pertain to the leased vehicle and the strength of the insurance providers (e.g., ratings) ____

Review insurance policies including:

Residual value insurance - credit union should receive the principal balance of the loan upon fruition of the lease term (NOTE: residual value insurance is necessary if the residual value used in the lease agreement is over 25 percent of the initial value of the vehicle) ____

Gap insurance - protects the credit union from loss due to the gap between the insurance company's book value of the vehicle and the credit union's principal balance of the vehicle in the event the car is stolen or wrecked beyond repair ____

Review insurance documents to ensure that all financed leased vehicles are covered by the policies (NOTE: if documentation does not specify the attachment of coverage to each individual vehicle, an attorney's opinion should be on file stating that blanket policy covers all financed leased vehicles) ____

Review whether the CUSO's insurance coverage is in compliance with applicable state and federal requirements ____

Review compliance with Regulation M ____

Financial Services CUSO

Additional Financial Services CUSO Review

(Includes Electronic Transaction Services, Financial Counseling Services, Real Estate Brokerage Services, and Insurance Brokerage or Agency)

Organization/Management
Review employees' compliance with licensing requirements ____

Inquire about training programs for the sale of nondeposit products (i.e., that training is provided to all employees that have direct contact with the members and imparts a thorough knowledge of the products involved, applicable legal restrictions, and customer protection requirements) ____

Inquire about the disciplinary actions in background of employees hired for the sale of nondeposit products ____

Review the need for SEC filings ____

Review compliance with Employment Retirement Income Security Act of 1974 if broker handles any retirement programs (e.g., credit union staff's pension) ____

Regulations/Legal
Review compliance with applicable sections of NCUA Letter No. 150 ____

Review compliance with the following:

Currency and foreign transactions ____
Posting of NCUA or other applicable insurance ____

Leasing Services

Review Leasing policies and procedures

Review contractual relationship between credit union and CUSO regarding delivery of CUSO leasing services ____

Refer to Leasing –Internal Controls questionnaire for guidance in reviewing leasing services ____

Trust and Trust Related Services

Review Trust Service policies and procedures ____

Review Trust Agreements with clients/customers ____

Review what steps are taken to ensure that the agreements are being followed. ____

Review minutes of any Trust related committee meetings ____

Review Auditors' verification of Trust account assets ____

Review vendor contracts ____

Review compliance with member confidentiality ____

Review Insurance/Bond coverage ____

FINANCIAL LIQUIDITY RATIOS - APPENDIX 25B

Liquidity is a measure of the quality and adequacy of current assets to meet current obligations as they come due.

- Current Ratio:

  $$\frac{\text{Total Current Assets}}{\text{Total Current Liabilities}}$$

This ratio is a rough indication of a firm's ability to service its current obligations. Generally, the higher the current ratio, the greater the cushion between current obligations and a firm's ability to pay them. The stronger ratio reflects a numerical superiority of current assets over current liabilities. However, the composition and quality of current assets is a critical factor in the analysis of an individual firm's liquidity.

- Quick Ratio (or Acid Test Ratio):

  $$\frac{\text{Cash \& Equivalents + Net Trade Receivables}}{\text{Total Current Liabilities}}$$

This ratio is a refinement of the current ratio and is a more conservative measure of liquidity. It expresses the degree to which a company's current liabilities are covered by the most liquid current assets. Generally, any value of less than 1 to 1 implies a reciprocal dependency on inventory or other current assets to liquidate short-term debt.

- Sales/Receivables:

  $$\frac{\text{Net Sales}}{\text{Net Trade Receivables}}$$

This ratio measures the number of times trade receivables turn over during the year. The higher the turnover of receivables, the shorter the time between sale and cash collection. For example, a company with sales of $720,000 and receivables of $120,000 would have a sales/receivables ratio of 6.0, which means receivables turn over six times a year. If a company's receivables appear to be turning slower than the rest of the industry, further research is needed, and the quality of the receivables should be examined closely.

One problem with this ratio is that it compares one day's receivables, shown at statement dates to total annual sales and does not take into consideration seasonal fluctuations. Another problem in interpretation may arise when there is a large proportion of cash sales to total sales.

- Day's Receivables:

  $$\frac{365}{\text{Sales/Receivable ratio}}$$

This figure expresses the average time in days that receivables are outstanding. Generally, the greater number of days outstanding, the greater the probability of delinquencies in accounts receivable. A comparison of a company's daily receivables may indicate the extent of a company's control over credit and collections. The terms offered by a company to its customers, however, may differ from terms within the industry and should be taken in to consideration.

In the example above, 365 divided by 6 = 61 - i.e., the average receivable is collected in 61 days.

- Cost of Sales/Inventory:

  $$\frac{\text{Cost of Sales}}{\text{Inventory}}$$

This ratio measures the number of times inventory is turned over during the year. High inventory turnover can indicate better liquidity or superior merchandising. Conversely, it can indicate a shortage of needed inventory for sales. Low inventory turnover can indicate poor liquidity, possible overstocking, obsolescence, or, in contrast to these negative interpretations, a planned inventory buildup in the case of material shortages. One problem with this ratio is that it compares one day's inventory to cost of goods sold and does not take seasonal fluctuations into account.

- Day's Inventory:

  $$\frac{365}{\text{Cost of Sales/Inventory Ratio}}$$

Division of the inventory turnover ratio into 365 days yields the average length of time units are in inventory.

- Cost of Sales/Payables:

  $$\frac{\text{Cost of Sales}}{\text{Trade Payables}}$$

This ratio measures the number of times trade payables turn over during the year. The higher the turnover of payables, the shorter the time between purchase and payment. If a company's payables appear to be turning more slowly than the industry, then the company may be experiencing cash shortages, disputing invoices with suppliers, enjoying extended terms, or deliberately expanding its trade credit. The ratio comparison of company to industry suggests the existence of these possible causes or others. If a firm buys on 30-day terms, it is reasonable to expect this ratio to turn over in appropriately 30 days.

One problem with the ratio is that it compares one day's payables to cost of goods sold and does not take seasonal fluctuations into account.

- Day's Payables:

  $$\frac{365}{\text{Cost of Sales/Payables Ratio}}$$

Division of the payables turnover ratio into 365 days yields the average length of time trade debt is outstanding.

- Sales/Working Capital:

  $$\frac{\text{Net Sales}}{\text{Net Working Capital}}$$

Working capital is a measure of the margin of protection for current creditors. It reflects the ability to finance current operations. Relating the level of sales arising from operations to the underlying working capital measures how efficiently working capital is employed. A low ratio may indicate an inefficient use of working capital while a very high ratio often signifies overtrading -- vulnerable position for creditors.

Coverage Ratios

Coverage ratios measures a firm's ability to service debt.

- Earnings Before Interest and Taxes (EBIT) Interest:
  Earnings Before Interest & Taxes
  Annual Interest Expense

This ratio is a measure of a firm's ability to meet interest payments. A high ratio may indicate that a borrower would have little difficulty in meeting the interest obligations of a loan. This ratio also serves as an indicator of a firm's capacity to take on additional debt.

- Net Profit, Depreciation, Depletion, Amortization/Current Maturities Long-Term Debt:
  Net Profit + Depreciation + Depletion + Amortization Expenses
  Current Portion of Long-Term Debt

This ratio expresses the coverage of current maturities by cash flow from operations. Since cash flow is the primary source of debt retirement, this ratio measures the ability of a firm to service principal repayment and is an indicator of additional debt capacity. Although it is misleading to think that all cash flow is available for debt service, the ratio is a valid measure of the ability to service long-term debt.

Leverage Ratios

Highly leveraged firms (those with heavy debt in relation to net worth) are more vulnerable to business downturns than those with lower debt to worth positions. While leverage ratios help to measure this vulnerability, remember they vary greatly depending on the requirements of particular industry groups.

- Fixed/Worth:
  Net Fixed Assets
  Tangible Net Worth

This ratio measures the extent to which owner's equity (capital) has been invested in plant and equipment (fixed assets). A lower ratio indicates a proportionately smaller investment in fixed assets in relation to net worth, and a better cushion for creditors in case of liquidation. Similarly, a higher ratio would indicate the opposite situation. The presence of substantial leased fixed assets (not shown on the balance sheet) may deceptively lower this ratio.

- Debt/Worth:
  Total Liabilities
  Tangible Net Worth

This ratio expresses the relationship between capital contributed by creditors and that contributed by owners. It expresses the degree of protection provided by the owners for the creditors. The higher the ratio, the greater the risk assumed by creditors. A lower ratio generally indicates greater long-term financial safety. A firm with a low debt/worth ratio usually has greater flexibility to borrow. In the future a more highly leverage company has a more limited debt capacity.

Operating Ratios

Operating ratios are designed to assist in the evaluation of management performance.

- % Profits Before Taxes/Tangible Net Worth

  $\frac{\text{Profit Before Taxes}}{\text{Tangible Net Worth}}$

This ratio expresses the rate of return on tangible capital employed. While it can serve as an indicator of management performance, it should be used in conjunction with other ratios. A high return, is normally associated with effective management and could indicate an undercapitalized firm whereas a low return is usually an indicator of inefficient management performance and could reflect a highly capitalized, conservatively operated business. This ratio is multiplied by 100 since it is shown as a percentage.

(NOTE: Profit before taxes may be zero, in which case the ratio is zero. Profits before taxes may be negative resulting in negative quotients.)

- % Profit Before Taxes/Total Assets

  $\frac{\text{Profit Before Taxes}}{\text{Total Assets}}$

This ratio expresses the pre-tax return on total assets and measures the effectiveness of management in employing the resources available to it. If a specific ratio varies considerably from industry standards, the analyst will need to examine the makeup of the assets and take a closer look at the earnings figure. A heavily depreciated plant and a large amount of intangible assets or unusual income or expense items will cause distortions of this ratio. This ratio is multiplied by 100 since it is shown as a percentage.

- Sales/Net Fixed Assets

  $\frac{\text{Net Sales}}{\text{Net Fixed Assets (Net of Accumulated Depreciation)}}$

This ratio is a measure of the productive use of a firm's fixed assets. Largely depreciated fixed assets or a labor intensive operation may cause a distortion of this ratio.

- Sales/Total Assets

  $\frac{\text{Net Sales}}{\text{Total Assets}}$

This ratio is a general measure of a firm's ability to generate sales in relation to total assets. It should be used only to compare firms within specific industry groups and in conjunction with other operating ratios to determine the effective employment of assets.

Expense to Sales Ratios

The following two ratios relate specific expense items to net sales and express this relationship as a percentage. Comparisons are convenient because the item, net sales, is used as a constant. Variations in these ratios are most pronounced between capital and labor intensive industries.

- % Depreciation, Depletion, Amortization/Sales

$$\frac{\text{Depreciation, Amortization, Depletion Expenses}}{\text{Net Sales}}$$

This ratio is the annual depreciation, amortization, and depletion expenses divided by net sales and multiplied by 100.

- % Officers', Directors', Owners' Compensation/Sales

$$\frac{\text{Officers', Directors', Owners' Compensation}}{\text{Net Sales}}$$

Annual officers', directors', owners' compensation divided by net sales and multiplied by 100. Included here are drawings of partners and proprietors, total salaries, bonuses, commissions, and other monetary remuneration to all officers; directors; and owners of the firm during the year covered by the statement.