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## ACCURATE AND CURRENT RECORDS ESSENTIAL

### PURPOSE OF RECORDS

The transactions of the credit union are compiled in its records which serve as a source of information needed by the directors to properly manage the credit union. The accounting records also serve as the basis for reports to the members and interested third parties. Therefore, it is essential that the records be accurate, current, and that they show the true financial condition of the credit union. Prompt preparation of reports will aid the credit union in achieving its objectives and fulfilling the purposes for which it was formed.

### BASIC ACCOUNTING RECORDS

Bookkeeping may be defined as the systematic recording of the financial transactions of a business in a suitable form. To accomplish this, a well-defined system of accounts is necessary.

### Double-Entry System

All federal credit unions should use a double-entry accounting system. In this system each transaction results in at least two entries: a debit (or entry on the left side of an account ledger) and a credit (or entry on the right side of an account ledger). If the transaction requires several debits and credits, the total of the debits and the total of the credits must be the same. In other words, for every debit entry there must be an offsetting credit entry and vice versa. Following this rule and determining that the total debits equal the total credits can keep the records in balance.

Record financial transactions as journal entries consisting of debits and credits. Every transaction affects at least two accounts. Accounting principles assign each type of account a normal debit or credit balance. The normal balance coincides with what is done to increase the balance in the account. For example, asset accounts are increased with debits; therefore, the normal balance in an asset account is a debit.

Debit refers to the left side of an account and credit refers to the right side. Calculate the account balance from the totals of the debit and credit sides of

an account and subtract the smaller sum from the larger; and the difference is called the balance of the account. Debits and credits affect asset and expense accounts in one way and liability, equity, and revenue accounts in the opposite way.

### Types Of Accounts

The "Asset Accounts" record what the credit union owns. These include cash, loans, investments, etc. These accounts, as well as the expense accounts, normally have debit balances.

The "Liability Accounts" record what the credit union owes and the "Equity Accounts" reflect the member's ownership interests. Together these accounts include notes payable, members' shares, undivided earnings and reserves. The "Liability Accounts" and "Equity Accounts" as well as the income accounts normally have credit balances.

A brief general rule for debits and credits is: Debit the increase of an asset, the reduction of a liability or equity account, or the payment of an expense; credit the reduction of an asset, increase of a liability or equity account or, receipt of income.

## BRIEF OUTLINE OF THE PRESCRIBED ACCOUNTING SYSTEM

The accounting records of federal credit unions should be maintained on either of two accounting bases: namely, the modified cash basis or the accrual basis. The accrual basis of accounting is recommended for credit unions with assets totaling \$2 million or more at the end of the accounting period.

### MODIFIED CASH BASIS

Generally under a cash basis of accounting, income is recorded and accounted for when actually collected and expenses are accounted for when actually paid. Under the modified cash basis prescribed herein, the accounting is based on the actual receipts and disbursements of the credit union except that provisions should be made to reflect:

- Liabilities which are not promptly paid when due,
- Dividends and interest refunds applicable to the accounting period but not yet paid,
- Deferred income or expenses applicable to future periods,
- Estimated losses to be sustained on loans outstanding,
- Estimated unrealized losses associated with mutual fund investments, and
- Depreciation on fixed assets.

The foregoing exceptions to maintenance of accounting records on a strictly cash basis are designed to recognize in the accounts certain significant financial transactions not involving the concurrent receipt or disbursement of cash and to reflect their effect in financial reports prepared from the accounts. In unusual circumstances, there may be other significant non-cash financial transactions that should be recorded. Therefore, the above list is not all-inclusive.

Credit unions for which adoption of the accrual basis of accounting is not required or practicable should use the modified cash basis of accounting.

### ACCRUAL BASIS

The accrual basis of accounting refers to that method under which liabilities and expenses are recorded when incurred, whether or not paid, and income is recorded when earned, whether or not received. It is intended that credit union accounting be maintained on the accrual basis by all credit unions for which they deem such basis practicable.

Generally accepted accounting principles require the accrual basis of accounting.

### THE BASIC CREDIT UNION ACCOUNTING SYSTEM DESCRIBED

For credit unions following either the accrual basis or the modified cash basis of accounting, the majority of entries originate with the receipt or disbursement of cash. Other entries are relatively

few in number and consist generally of adjustments or transfers between accounts, establishment and maintenance of an allowance for loan losses, write-offs of bad loans, and recording depreciation of tangible fixed assets. In addition, credit unions following the accrual basis of accounting should make entries to record accrued income and expenses.

### **Records Of Original Entry And Record Of Final Entry**

A bookkeeping system can be broken down into two distinct parts: Records of Original Entry (the Journal and Cash Record) and Records of Final Entry (the General Ledger). In addition, the Cash Received Voucher or its equivalent and the Journal Voucher or its equivalent serve as memorandum records of the original transactions and the sources of entries in the Journal and Cash Record.

#### **The Records Of Original Entry**

The Records of Original Entry are diaries of the transactions as they occur. The Journal and Cash Record is the main record used for this purpose. Each day's cash receipts, disbursements and other transactions are entered in the Journal and Cash Record in chronological sequence. Thus, a running history of each day's transactions are kept and may be summarized as needed.

At the end of a given period, usually the month end, the total of all transactions pertaining to each account can be obtained by totaling the debit and credit columns of the Journal and Cash Record. The accuracy of the entries can be proved in part by balancing the debit columns against the credit columns.

#### **The Record Of Final Entry**

The Record of Final Entry is the General Ledger. This record serves as a means of summarizing the entries in a form that will enable the bookkeeper to prepare reports on the results of operations to date. Entries in the General Ledger consist of posting (simply transferring) the debits and credits (either individually or in total at the end of the month) for each account in the Journal and Cash Record to the corresponding account in the General Ledger and

computing the net balance for each account. The result obtained shows the current balances of the credit union's accounts and the results of operations for the period.

Sometimes, when a General Ledger account summarizes a large number of transactions, it is necessary to provide detailed information about this account with a record known as a Subsidiary Ledger. The Individual Share and Loan Ledgers are examples of subsidiary records which show the detailed share and loan transactions with each member. The Share and Loan accounts in the General Ledger reflect the total transactions with all members. These General Ledger accounts are called Control Accounts since they act as a control or check over the numerous postings to the individual or subsidiary ledgers. Subsidiary records are balanced with related control accounts on a monthly basis and the reconciliation, or other proof of balancing, is retained.

## **BASIC CONCEPTS AND GENERAL PRINCIPLES**

The basic concepts and general principles of the detailed accounting principles and standards for federal credit unions are:

### **SEPARATE ENTERPRISE**

Each credit union is a separate corporate enterprise requiring the maintenance of comprehensive accounting records and financial reporting practices to provide meaningful information to members, officers, directors, the supervisory committee, the National Credit Union Administration (NCUA), and interested third parties.

### **GOING CONCERN CONCEPT**

Each credit union should normally maintain its accounts as a "going concern" on the basis that its operations will continue indefinitely. Therefore, assets and liabilities should represent the value to the credit union as a "going concern" and should not present liquidation values.

Whenever unusual circumstances indicate a limited life for a credit union, e.g., if the credit union liqui-

dates, the "going concern" concept no longer applies. As a result, a statement of realistic assets and liabilities and appropriate revenues and expenses may require adjustments. These adjustments could include:

- Re-evaluation of the loan portfolio to recognize discounts on sales of loans,
- Evaluation of the realizable value of fixed assets in liquidation, and
- Re-evaluation of the carrying value of deferred charges and deferred credits, etc.

### **MONETARY BASIS FOR ACCOUNTING**

State account values in terms of the dollar amounts involved at the time transactions occur. Recording each transaction in terms of dollar units provides the best feasible indicator of its relative impact on the overall operations of the credit union. It also permits identification of the amount of assets, liabilities, equity, income, or expenses represented by the transaction.

### **CONSISTENCY IN ACCOUNTING FROM PERIOD TO PERIOD**

Follow consistent accounting practices from one accounting period to the next. Should a material change in accounting treatment occur, disclose the facts on credit union financial statements. Include the dollar effect upon the balance sheet and the changes in net income for the period. For example, if a credit union converts to the accrual system of accounting because assets exceed \$10 million, it should make a complete conversion at one time and report the conversion on the current period financial statements.

### **TIMELY RECOGNITION IN ACCOUNTING RECORDS**

Record accounting transactions in a timely manner so all material information applicable to each accounting period shows in the records. Provide for estimated losses to be sustained in the collection or conversion of loans and other assets via charges against current expenses to properly recognize the reasonable value of assets, liabilities, and share-

holders' equity in accounting records and financial reports. Estimate amounts for accruing income or expenses if actual amounts are not known and cannot be determined readily. Absorb differences between the actual and estimated amounts in the operations of the subsequent accounting period.

### **MATERIALITY**

Recognize material facts relating to credit union financial activity in the accounts and report them on financial statements. GAAP provides that a statement, fact, or item is material if, giving full consideration to the surrounding circumstances as they exist at the time, it is of such a nature that its disclosure, or the method of treating it, would be likely to influence or to "make a difference" in the judgment and conduct of a reasonable person. The accumulation of many small items, each of which in itself would not be "material", would be "material" if the overall effect would tend to influence the judgment and conduct of a reasonable person.

### **CONSERVATIVE ACCOUNTING**

Maintain accounting records on a conservative basis. Make reasonable provisions in the accounts for potential losses on assets and for the settlement of liabilities. Do not materially overstate nor understate its assets, liabilities, revenues or expenses.

### **INTERNAL CONTROL**

Adopt appropriate measures of internal control to improve the dependability of accounting records. These measures must include:

- An organization plan to provide, to the extent feasible, segregations of duties so different employees will handle the operational, custodial and accounting functions;
- A system of authorization and recording procedures adequate to provide reasonable accounting control over assets, liabilities, income and expenses;
- The employment of personnel capable of performing duties and responsibilities; and

- A supervisory committee to conduct effective and timely audits of records and accounts including verification of members' accounts, with assistance provided, where needed, by an independent auditing firm.

### **COMPLETE RECORDING OF INCOME AND EXPENSES**

Record income, expenses, gains, and losses in income and expense accounts and show them on the Statement of Income for the accounting period. Income and expense accounts should include actual and estimated loan and other asset losses.

### **ACCOUNTING BASIS**

GAAP requires the accrual basis of accounting because it provides the most complete and informative record of financial activities. The accrual basis refers to recording liabilities and expenses when incurred, whether or not paid, and income when earned, whether or not received. Credit unions with less than \$10 million in assets do not have to adopt the full accrual basis of accounting. The alternative method is the modified cash basis of accounting. When a credit union's assets reach \$10 million or greater, management must convert to the accrual basis of accounting.

Determine the proper accounting basis using the following guidelines:

- If assets total \$2 million or more at the end of the accounting period, adoption of the accrual basis is *recommended*;
- If the board of directors deems the accrual basis practicable, use the accrual basis;
- If following the accrual basis, credit unions with less than \$10 million in assets may apply the cash basis to particular accounts where the results would be only insignificantly different from the accrual basis. For this purpose, "insignificantly" refers to differences which would not be considered important for a proper evaluation of condition or operations of the credit union; and

- If adoption of the accrual basis is not required or practicable, use the modified cash basis. Under the modified cash basis, accounting is based upon the cash receipt and disbursement transactions except to make provision to reflect:

- a) Liabilities not paid promptly when due;
- b) Dividends and interest refunds applicable to the accounting period but not yet paid;
- c) Deferred credits and charges applicable to future periods;
- d) Estimated losses to be sustained on loans outstanding and other risk assets; and
- e) Depreciation of fixed assets.

### **ACCOUNTING AND DIVIDEND PERIODS**

Accounting periods may be monthly, quarterly, semiannually, or annually depending on the period selected by the credit union to close its books. Each credit union must close its books at least annually at the end of the fiscal year. Federal credit unions *may choose* to close the books at the end of each regular share account dividend period unless dividends are paid more frequently than monthly.

### **FISCAL YEAR**

The fiscal year of all federal credit unions should track the calendar year beginning on January 1 and ending on December 31.

### **ACCOUNTING PROFESSION PRONOUNCEMENTS**

Alternatives to the accounting principles authorized by the NCUA -- for certain types of transactions -- are provided for adoption at the option of any credit union with less than \$10 million in assets. These alternatives provide the flexibility required for meaningful accounting under a variety of circumstances in credit unions of different size and scope of operations. *Absolute uniformity is not required so long as each credit union conforms its accounting to authorized generally accepted accounting principles.* Consistency in accounting from period

to period and disclosure of material accounting changes is necessary.

The Financial Accounting Standards Board (FASB), the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA), and their committees establish generally accepted accounting principles (GAAP), accounting guidelines, and preferred accounting treatment for various activities. Credit unions should refer to such accounting profession pronouncements for guidance where a particular activity is not addressed by this manual or other NCUA publications. Credit unions may adopt such accounting profession pronouncements provided they are not inconsistent with the principles, standards, and procedures set forth herein or statutory or regulatory requirements.

Refer activities unique to credit unions and not addressed in existing accounting industry literature or in NCUA publications to an independent accountant for review and comment. Copies of the correspondence should be maintained in the credit union's files.

### **HIERARCHY OF GAAP STANDARDS**

External sources such as the FASB issue accounting standards in multiple forms. Following is the hierarchy of standards:

1. FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins;
2. FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position;
3. Consensus positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins;
4. AICPA accounting interpretations, "Qs and As" published by the FASB staff, as well as industry practices widely recognized and prevalent; and
5. Other accounting literature, including FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; GASB Statements, Interpretations, and

Technical Bulletins; pronouncements of other professional associations or regulatory agencies; AICPA Technical Practice Aids, and accounting textbooks, handbooks, and articles.

### **HIERARCHY OF REGULATIONS**

The NCUA issues guidance in multiple forms. As management refers to the various forms of guidance, it is important to utilize the hierarchy of regulations:

1. Federal Credit Union Act,
2. NCUA Rules and Regulations,
3. NCUA Interpretive Ruling and Policy Statement (IRPS) – if the IRPS was issued "for notice and comment", it has the same force as the NCUA Rules and Regulations, and
4. All other forms of regulatory guidance including:
  - Federal Credit Union Bylaws,
  - NCUA Letters to Credit Unions,
  - NCUA Instructions,
  - The NCUA Accounting Manual, and
  - NCUA General Counsel Opinions.

## **GENERAL LEDGER, SUBSIDIARY LEDGERS, AND ACCOUNT RECONCILIATIONS**

### **CHART OF ACCOUNTS**

Federal credit unions must design their own chart of accounts. Management is responsible for reporting financial information to the NCUA on the periodic Call Report. Therefore, we recommend the credit union's chart of accounts closely mirror the Call Report for ease of reporting. Use the prescribed financial report forms in Section 900 as a guide for financial reports intended for posting to members.



Whatever chart of accounts numbering system management adopts for its general ledger accounts, it should permit the classification of transactions in at least the detail required to properly complete the NCUA call report forms.

### **GENERAL LEDGER**

The general ledger is a comprehensive record of individual accounts on the chart of accounts. The chart of accounts is a listing of general ledger account numbers and account names. The general ledger accounts contain entries pertaining to a specific asset, liability, equity, income, or expense. Some computer systems will print various levels of detail for general ledger reports. Subsidiary ledgers and account reconciliations support the general ledger.

### **SUBSIDIARY LEDGERS**

Subsidiary ledgers store the details of certain general ledger accounts. Subsidiary ledgers support general ledger accounts. Use of subsidiary ledgers may reduce the number of general ledger accounts. The fewer the number of accounts, the easier it is to avoid errors and find them when they occur. Subsidiary ledgers are often set up for loans, cash, investments, prepaid expenses, fixed assets, shares, equity, income, and operating expenses. The better the system of organizing account details in subsidiary ledgers, the easier it is to avoid errors and find them when they occur.

### **ACCOUNT RECONCILIATIONS**

Account reconciliations prove account balances on a regular basis. Staff will typically prepare these at least monthly. Accounts such as corporate investments may require reconciliation weekly or daily. Reconciliations are not necessary for all accounts. Management's written policy or procedures will guide staff to complete reconciliations appropriate for the credit union.

## **PRINCIPLES AFFECTING THE RECORDING OF ASSETS**

### **UNDER THE MODIFIED CASH BASIS OF ACCOUNTING**

The principles and standards of accounting relating to assets of federal credit unions following the modified cash basis of accounting are set forth below.

#### **Assets – General Basis for Recording**

Record assets at their cost to the credit union, normally. There are some exceptions to this rule, e.g., available-for-sale and trading securities.

#### **Cash – Unrestricted or Restricted**

Record *restricted* cash on deposit or on hand in separate accounts from other cash accounts. Show each category of *restricted* cash separately on financial reports, other than change funds or petty cash.

#### **Loans**

Record the unpaid balances of loans outstanding and other receivables. Maintain appropriate valuation allowance accounts to cover estimated losses. Under the accrual basis of accounting, amortize net loan origination fees and costs over the life of the related loans using the interest method. Under the modified cash basis of accounting, at a minimum, amortize origination fees over 10 years or the life of the loan, whichever period is shorter.

#### **Investments**

Record investments and related transactions based on the principles and standards described below. Generally, depository instruments are recorded at amortized cost while securities are recorded as follows:

- Classify *debt and equity* securities purchased and held principally for the purpose of selling them in the near term as *trading securities* and report at fair value through the income statement.
- Classify *debt* securities (not equity) management has the positive intent and ability to hold to maturity as *securities held-to-maturity* and

report at amortized cost, i.e., cost adjusted for the amortization of premiums or the accretion of discounts.

- Classify *debt and equity* securities not classified as either *trading* or *held-to-maturity* securities as *securities available-for-sale*. Report at fair value through a separate component of equity in the balance sheet, *Accumulated Unrealized Gains/Losses on Available-for-Sale Securities*, an item of Other Comprehensive Income.
- Amortize *premiums paid for securities* using the interest method by periodic entries offsetting income on investments over the period from acquisition to maturity. Record amortization on a timely basis corresponding to the recording of the related income. If interest on investments is recorded at the time the income is received by cash payments, record the premium amortization similarly.
- Record *discounts on securities* using the interest method as income over the period from acquisition to maturity by periodic entries augmenting income from investments. Coordinate entries to record the write-off of discounts with the recording of the related income.
- Record *income earned on investments* as income when received. An exception is income automatically reinvested in common trust investments, marketable equity securities, bank passbook accounts, savings and loan shares, which should be recorded as an increase in the carrying value of the investments when notice of income credits are received by the credit union; the offsetting credit should be to income from investments; and
- Record *accrued interest purchased on bonds and securities* as an asset and clear it by an offset against interest received when the first interest payment on the related securities is received.

Refer to Section 300 of this manual for more detailed information regarding investments.

### Fixed Assets

Record fixed assets in accordance with the following principles:

- Record *acquisitions of tangible fixed assets* at cost. The acquisition cost is the net purchase price of the asset plus all incidental costs necessary to put the asset in condition for use, such as freight and installation cost. If management exchanges property for an asset, record cost as the amount of cash paid plus the recorded amount of the asset surrendered. Do not recognize a gain, if any, on the transaction; do recognize the entire loss on the exchange, if any. If management acquires property via exchange without cost, use the fair market value as the “cost”;
- Establish a dollar value limit, i.e., \$250, under which management records tangible property purchases as current expense even though the items may be serviceable for more than 1 year;
- Show cost of land (and land improvements) separately from the cost of the buildings and other improvements. In combination purchases, record the cost of land based on a fair market value estimate;

### Depreciation

Fixed asset depreciation is a system of distributing the cost and other basic values of fixed assets less salvage over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. Record depreciation in each accounting period by debiting expense and crediting valuation allowance accounts under either of two bases:

- Use the *unit depreciation basis* to record depreciation over the estimated useful lives of assets based on the cost of the assets less estimated salvage value. For assets having a remaining use, the depreciation shall not exceed the carrying value of the asset less:
  - a) the salvage value, or
  - b) \$1.00.

Maintain a depreciation record for each depreciable item. Management may use either the straight-line, declining balance, or the sum of years' digits methods for the purpose of computing the periodic amounts of the depreciation to be charged; and

- Under the *composite basis*, record depreciation continuously based on established composite rates. The accumulated depreciation allowance account under the composite-life method of depreciation cannot exceed the related fixed assets account.

### Prepaid Expenses and Deferred Charges

Record costs affecting subsequent accounting periods as prepaid expenses, if material in amount, and amortize them over the accounting periods to which applicable. Examples include insurance premiums, stationery and supplies, advances for accounting services, annual share insurance premium, NCUA operating fee, and organization costs. Amortize deferred organization costs over a period not extending beyond the year incurred and the two subsequent fiscal years.

### Assets Pledged

Disclose the nature and extent of credit union assets pledged to secure debts in the financial statements.

### UNDER THE ACCRUAL BASIS OF ACCOUNTING

Apply the principles and standards of the modified cash basis of accounting except as noted below.

#### Income on Loans

Accrue interest earned each month or dividend period on loans outstanding, as a debit to assets and a credit to income. Do not accrue interest on loans 3 months or more delinquent.

#### Income on Investments

Accrue income on investments each month or dividend period based on the time the investments were held and the income was not received.

### Amortization of Premium or Discount on Securities Purchased

Whether management accrues interest on investments monthly, quarterly, semiannually, or annually, record the premium amortization based on the same time periods. Likewise, accrete discounts on securities via periodic entries increasing accrued income from investments. Record entries to write-off the discount within the same periods of time.

## PRINCIPLES AFFECTING THE RECORDING OF LIABILITIES

### UNDER THE MODIFIED CASH BASIS OF ACCOUNTING

#### Liabilities – General Basis for Recording

Record known liabilities at their actual amounts or, if the actual amounts are not known, record them based on reasonably accurate estimates.

#### Accounts Payable

Record all bills due and unpaid as accounts payable if not paid before the end of the period.

#### Notes Payable

Record funds borrowed to show the outstanding amount payable on the notes. Include balances of senior liens on assets repossessed or foreclosed where the credit union acquires title subject to the prior liens.

#### Accrued Interest Payable

If management records accrued interest, the offsetting charge is the expense account, Interest on Borrowed Money. Recording accruals of interest due on notes payable is not required.

#### Dividends Payable

Upon declaration of a dividend, record the actual or estimated amount payable as a liability unless the dividend is paid or credited to share accounts in the

last month of the dividend period. Offset the charge to Dividend Expense or Accrued Dividends Payable.

### Interest Refund Payable

Upon declaration of an interest refund, record the actual or estimated amount payable as a liability unless the refund is paid or credited to share accounts in the last month of the dividend period. Offset the charge to Interest Refunds. Management may record estimated interest refunds monthly.

### Accrued Expenses

When expenses are not paid promptly, accrue them as liabilities and debit expenses. When disbursement takes place, reverse these liabilities. Except for dividends, credit unions following the modified cash basis are not required to accrue expenses and allocate the costs to the periods benefited.

### Accrued Dividends

Whenever management specifies or contracts a dividend rate on any type of account in advance, accrue the expense monthly or at the end of the shortest dividend period offered by the credit union on any type of account. The only exception to this rule is, accruals are never required more frequently than monthly.

Dividends in any dividend period cannot exceed:

- a) Undivided earnings available at the beginning of the period;
- b) Plus — net income (or less net loss) before dividends for the current dividend period.

### Deferred Credits

Deferred credits include discounts on FHA loans and discount on loans purchased from other credit unions. Record deferred credits separately and amortize by crediting income during subsequent periods as the income is earned. Report the amounts of discounts on loans recorded as deferred credits as deductions from the related asset accounts in financial reports.

### Liabilities Secured by Liens

Report the nature and extent to which particular liabilities are secured by a lien on assets on the financial statements.

### Contingent Liabilities

A contingency is an existing condition, situation, or set of circumstances that may or may not result in a gain or loss to the credit union. The amount of the resulting gain or loss will be determined by future event(s). Accrue the amount of a contingent loss by charges to expense if:

- Prior to issuing financial statements, it is probable a loss will actually occur because an asset was impaired or a liability was incurred on the date of the financial statements; and
- Management can make a reasonable estimate of the resulting loss.

*Note:* Estimate the amount of the accrued contingent loss realistically based on all information available. If some amount within a range appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. If no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued.

If both of the above conditions are not met but a reasonable possibility exists that a loss may have been incurred, or if the estimated amount is not material, a contingent loss need not be accrued but disclosed as a note to the financial statements.

Examples of contingent liabilities are pending or threatened litigation, selling loans with recourse, guarantees of the indebtedness of others, and agreements to repurchase assets sold previously.

### **UNDER THE ACCRUAL BASIS OF ACCOUNTING**

The principles and standards applicable to the modified cash basis of accounting apply under accrual basis of accounting, except as follows.

**Accrued Interest Payable**

Record in each month or dividend period the accrued interest payable on notes and mortgages with an offsetting debit to interest expense.

**Accrued Expenses**

Examples of accrued expenses are dividends and salaries. Accrue expenses to allocate costs to the periods benefited. Record the accruals normally each month or dividend period so all significant expenses are shown on financial reports provided to directors and members.

**PRINCIPLES AFFECTING EQUITY****NET INCOME**

The net income or loss for the current accounting period should represent the difference between all income and expense items.

**UNDIVIDED EARNINGS**

At the close of each accounting period, close the income and expense accounts into the Net Income (Loss) account. Then transfer the balance of the Net Income (Loss) account to Undivided Earnings.

Debit or credit undivided earnings with amounts required to establish or adjust other appropriation accounts, including the appropriation for loss contingencies or the special appropriation for losses established when so ordered by the NCUA Board. Other direct charges or credits to undivided earnings only include error correction for material amounts which represent adjustments affecting prior accounting periods. Material errors in such financial statements could include arithmetic mistakes, the misuse or deletions of information, mistakes in the applications of accounting principles or procedures, and improper interpretations of the accounting aspects of major transactions. Error correction should not result in the restatement of the prior year's financial statements to disclose the error correction but should be reflected in current period financial statements and those going forward.

Do not treat normal recurring corrections and adjustments which are the natural result of the use of estimates inherent in the accounting process as prior-year adjustments. Normal recurring corrections include changes in estimated loan losses, accumulated depreciation on disposed assets, and estimated dividends. These changes are properly recorded as transactions affecting the current year in the appropriate income and expense accounts. The determination of net income for the period must include all items of profit and loss recognized during a period, including accruals of estimated loss from loss contingencies.

**DIVIDENDS**

Declare and pay dividends to shareholders from current income, plus any available balances of undivided earnings. Charge the dividends as a current year expense. Management should use caution in expending undivided earnings to meet current operating expenses, particularly for payment of above market dividends. Rather, credit unions should strive to build capital.

**APPROPRIATION FOR LOSS CONTINGENCIES**

Management can establish an appropriation for contingencies for possible or unforeseen decreases in the value of assets or for other unforeseen or indeterminate liabilities not otherwise shown on the credit union's records. Any such appropriation established only as a precautionary measure will represent a segregation of undivided earnings and should be so classified in financial reports. Do not use contingency appropriations as a substitute for valuation requirements for the amount of currently estimated losses on loans or other assets. When the net loss during any accounting period exceeds available undivided earnings, reduce the appropriation for loss contingencies and/or other segregations of undivided earnings to offset such excess.

Even if management established an Appropriation for Loss Contingencies for a particular liability or expenditure, do not charge such expenditures directly to the appropriation. Record the loss or cost as an operating expense.

Establish the Appropriation for Loss Contingencies for a particular event by a debit to Undivided Earnings. When the event occurs, or the liability is paid, credit the balance of the account back to Undivided Earnings. Transfers from the Appropriation for Loss Contingencies to Undivided Earnings must be in amounts equal to costs charged to expenses during an accounting period, thereby eliminating any reduction in Undivided Earnings which would have occurred due to the contingency taking place.

### **DONATIONS**

GAAP affects how credit unions with \$10 million or more in assets measure and disclose donated assets and services on their financial statements. Credit unions under \$10 million in assets may follow GAAP or the regulatory-basis of accounting described herein. Regardless of the method used, management must consistently apply the method they choose, GAAP or regulatory-basis, as outlined in this section.

From a regulatory perspective, NCUA considers the donation of assets and services from a sponsor to a credit union as a reciprocal transfer (i.e., in return, sponsor gets the fringe benefit to employees of on-site financial services). Thus, management does not have to report the donation of assets and services by the sponsor on their financial statements. From a GAAP perspective, management must recognize the fair value of the contributed use of facilities or other services as both a revenue and an expense in the period received and expended.

Under GAAP, record donations and gifts received (including donations made for the specified purpose of enabling the credit union to pay dividends) as income and show them as part of net income for the current month. The regulatory approach provides as an exception to the foregoing, if a credit union receives a gift of a tangible fixed asset of substantial value (i.e., a building or a computer) in order to exclude such amounts from current income and undivided earnings, offset the entry for the fair market value of the asset recorded in the fixed asset account to Donated Equity. Depreciate these donated assets via charges to expense over their remaining useful lives.

GAAP requires inclusion of all contributions made or received in expense/income when made/received. Contributions include many of the “donations” credit unions receive (i.e., office space, telephone services, data processing support); and some volunteer services (i.e., some accounting/auditing services, some legal advice, etc.). Under GAAP:

- Recognize some contributions simultaneously received and used as both a revenue and an expense in the period received and used (i.e., sponsor-contributed utilities); and
- Treat contribution of office space as above (i.e., revenue and expense) as long as the sponsoring entity could discontinue providing the space at any time. If the sponsoring entity provides the facility for a specified period of time (i.e., 5 years), the promise must be set up as a receivable at its fair value.

Recognize contributed services as both a revenue and an expense if the services received:

- 1) Create or enhance non-financial assets, or
- 2) Require specialized skills, are provided by individuals possessing those skills, and are typically purchased if not donated.

For example, if the above two conditions are met, GAAP requires recognition of an audit performed by uncompensated Supervisory Committee members as a revenue and an expense on the credit union’s books.

### **SHARES AS EQUITY**

Classify shares as equity in the Statement of Financial Condition:

- The Federal Credit Union Act, as amended by the Competitive Equality Banking Act (CEBA) of 1987, legally defines shares as equity;
- Shares function as equity and represent ownership; and
- Share dividends are based on earnings and are not guaranteed.

In some jurisdictions, boards of directors may allow individual members to deposit more than the member's ownership interest. In these cases, management should properly classify excess shares as liabilities on the Statement of Financial Condition.

## PRINCIPLES AFFECTING THE RECORDING OF INCOME AND EXPENSES

### UNDER THE MODIFIED CASH BASIS OF ACCOUNTING

The principles and standards of accounting relating to income, expenses, gains, and losses of federal credit unions following the modified cash basis of accounting are set forth below.

#### General Rules for Recording Income and Expenses

Record all income, expenses, gains, and losses affecting each accounting or dividend period through income and expense accounts. To correct an error affecting prior accounting period operations, refer to GAAP.

#### Basis for Recording Income

Record income periodically as received. Record fees and late charges as income when received.

#### Basis for Recording Expenses

Expenses are the uses and consumption of goods and services in the process of producing income. Pay and record expenses related to current operations promptly when due. Record all expenses incurred but not paid at the end of the month as current month expenses: as accounts payable or accrued expenses. Record significant amounts of expenses paid or accrued if applicable to future periods as prepaid or deferred expenses and amortize them over the periods to which they apply.

#### Tangible Fixed Asset Expenses

Expense depreciation of fixed assets over the useful lives of the assets under the unit or the composite basis.

- When management computes depreciation on a unit basis, eliminate the amount of the retired asset together -- including any related depreciation allowance. Record any material difference between the net amount realized from disposition and the net carrying value of the depreciable assets as an "other gain or loss" and show it in financial reports separate from regular operating income or expense; and
- When management computes depreciation on a composite-life basis, credit the cost of retired units to the appropriate fixed asset account; charge the same amount less salvage value to the allowance for depreciation account. Do not recognize gain or loss in the accounts since items in the group will retire both before and after expiration of the estimated average life. When retirements are abnormal or unusual, record gains or losses in the accounts, similar to the unit basis since composite rates do not anticipate such retirements.

#### Amortization of Deferred Charges

Examples of deferred charges include prepaid insurance, leasehold improvements, and organization expenses. Include debits in expenses each month or dividend period for amortization of deferred charges.

#### Equipment Rental Expense

Charge rental charges under equipment leases directly to expense unless they represent installment purchases of fixed assets. If a rental agreement represents an optional purchase contract the credit union plans to exercise by purchasing the equipment, record the cost of the equipment as a fixed asset and a liability. Thereafter, payments made will reduce the liability amount, and management will record appropriate depreciation expense. Refer to GAAP for further guidance.

### Loan Losses

Record losses on loans and related assets as described below:

- Charge off loan losses as they occur, with the approval of the board of directors, by debits to Allowance for Loan Losses. Record recoveries on loans charged off, as they occur, as credits to Allowance for Loan Losses;
- Establish and maintain Allowance for Loan Loss to reflect the estimated amount of losses on:
  - (1) Originated member loans.
  - (2) Loans purchased from other credit unions.
  - (3) Lease receivables.

The value of the allowance account should be adjusted monthly or at the end of the regular share dividend period, if longer than monthly. For this purpose, management should determine the amount of the allowance adjustment based on a logical, documented, defensible method which will result in the estimation of all probable losses inherent in the loan portfolio as a given date, and (losses) which are reasonably estimable.

### Other Gains and Losses

Normally include other gains and losses when determining periodic net earnings or losses. Report non-recurring gains or losses (those unrelated to ordinary credit union activities) separately as non-operating income or expense on periodic income and expense statements. For example, charge a gain or loss from the sale of a credit union office building, and any loss charged off on a note or contract taken in connection with a sale of credit union office quarters to Other Losses.

### Cash Overage and Shortages

Record cash overages and shortages from the processing of cash transactions as debits or credits to expense daily. Adjust the cash over and short expense accounts whenever the reason for the cash overage or shortage is determined. Consider any

overage or shortage in negotiable instruments a "cash overage or shortage" and record the appropriate adjustment at least prior to the close of each month.

### Donations

Refer to the discussion in Principles Affecting the Recording of Equity.

### Pension Plan Costs

Pension plan accounting is beyond the scope of this publication. Seek assistance from an independent accountant.

### NCUA Insurance Guaranty

Do not record any guaranty provided by the NCUA to a credit union to make it insurable under Title 11 of the Federal Credit Union Act, as amended. This guaranty represents a claim by the credit union against the NCUA which is payable only in the event of liquidation of the credit union and then only to the extent needed to reduce or eliminate loss claims against the Title 11 share insurance fund. Amortize guaranties through charges to expense in accordance with the terms of the guaranty agreement.

## UNDER THE ACCRUAL BASIS OF ACCOUNTING

The principles and standards of accounting applicable to the modified cash basis of accounting apply under the accrual basis of accounting, except as follows:

### Income on Loans

Record interest income earned each month or dividend period on loans outstanding as income and as an asset although it may not have been received. Many computerized loan systems will calculate the amount to accrue. Maintain supporting documentation for the accrual.

### Income on Investments

Management should record income as noted:



- Record income for investments in savings and loan associations and other credit unions in each month or dividend period the investments are held and the interest or dividend income was not received. For example, accrue the amount of each quarterly or other distribution applicable to each dividend period as Accrued Income on Investments with an offsetting entry to Income from Investments;
- Record income for mutual fund and common trust investments as income for the month or dividend period based on the time the investments are owned. Adjust the amount each month or dividend period as required based on the change in value. If management receives income during the period, record the amount as the actual amount of interest earned for the preceding period;
- Record income for other investments each month or dividend period based on the actual time the investments are held and interest or dividend income was not received. Recognize the amount earned as income and as an asset. Accrue interest earned on the general type of government securities each month or dividend period based on the applicable portion of the semiannual interest. Accrue interest on appreciation-type savings bonds in each month or dividend period based on the pro rata amount of the bond appreciation for the period shown on the bond's table of redemption values. Accrue interest on loans to other credit unions, certificates of deposit and deposits in other credit unions to record interest earned each month or dividend period based on the actual time the investments or deposits are held; and
- Record differences between the amount of income accrued and actual income in the appropriate accounts when income is received.

### Accrued Expenses

Expense accruals include, but are not limited to, charges to expense for unpaid salaries, uncompensated leave, dividends, supervisory committee audit, taxes, and interest on borrowed funds. Pay or accrue expenses and match them against period-

ic revenues with offsetting credits, where necessary, to cash, payables, or accrued expenses.

### Accrued Interest on Loans Included in Valuation Allowance

Include an amount to cover potential losses on accrued interest receivable from loans in the valuation allowance for estimated losses on outstanding loans. Do not accrue interest on any loans 3 months or more delinquent. Reverse previously accrued interest on such loans via appropriate entries to Accrued Interest and Interest Income.

## FINANCIAL STATEMENTS

### PURPOSE

Federal credit unions' financial statements must present their financial position fairly as of a particular date. This is the most important external function of the accounting process. Financial statements must be posted in a conspicuous location for the information of members at each credit union location and as required by the NCUA. The results of operations for a particular period must follow GAAP if assets are \$10 million or more. Other credit unions may follow GAAP and must follow the principles prescribed herein. Management uses financial statements to:

- Make sound decisions,
- Effectively manage the credit union, and
- Show how management has carried out its stewardship to shareholders, creditors, and others having an interest in the credit union.

### REQUIRED STATEMENTS

Management must prepare two financial statements every month for internal and external use. These statements are:

- Statement of Financial Condition, and
- Statement of Income.

### Statement of Financial Condition

The Statement of Financial Condition (balance sheet) and notes thereto should show the financial condition of the credit union as of the date it represents. The statement should:

- Recognize the basic concepts of the principles and standards of accounting by showing, on a conservative basis, assets and liabilities including contingent losses, appropriate classifications of credit union equity; and identify any significant changes in the supporting accounting practices from those used in the previous presentation;
- Provide valuation allowances as deductions from related assets to show estimated amounts of losses as well as depreciation on tangible assets. Management should include estimated losses to be sustained in collateral collection or value realization;
- Separate unrestricted cash and restricted cash, and identify the nature and extent of any assets pledged or hypothecated;
- Reflect the nature and extent to which specific liabilities are preferred liens on assets; i.e., indicate for any real estate mortgage the particular assets pledged as security;

### Statement of Income

This statement and notes thereto should reflect all income, expenses, gains, and losses of the credit union for the period for which prepared. It should:

- Reflect the results of operations in accordance with GAAP or at a minimum, the principles prescribed herein;
- Segregate regular operating income, expense, gains, and losses from any extraordinary income, expense, gains, or losses;
- Include within regular operations, increases and decreases in the valuation allowance established for estimated losses on loans and loan assets; and

- Include as income all fees and charges made to members and borrowers.

### Notes To Financial Statements

The objective of notes to financial statements is to provide information not sufficiently described within the body of the financial statements. Notes to financial statements are an integral part of the statements and should provide:

- a) A description of significant accounting policies followed;
- b) An explanation of changes in methods or techniques of handling accounting transactions;
- c) An explanation of creditors' rights to specifically pledged assets;
- d) A disclosure of contingent assets and liabilities, restrictions on dividend payments, and executory contracts; and
- e) The market value of investments.

### Disclosures About Fair Values of Financial Instruments

Credit unions with less than \$10 million in assets may wish to disclose, either in the body of the financial statements or in the accompanying footnotes, the fair values of financial instruments on their statements of financial condition. GAAP generally exempts all entities with assets of \$100 million or less from fair value disclosure requirements.

The disclosure may be advisable for all financial instruments, both assets and liabilities, recognized and not recognized in the statement of financial condition, *for which it is practicable to estimate fair value*. Refer to GAAP for guidance. It details procedures for estimating the fair value of "financial instruments" and illustrations for applying the disclosure requirements about fair value of financial instruments. For those affected credit unions, we recommend management obtain a copy of GAAP and prepare a financial statement footnote including the methods for establishing the fair val-

ue of the assets, liabilities, and equity. These methods should provide the basis for the dollar estimates of the fair value. Retain historical records of your fair value calculations based on these methods and maintain an overall policy documenting these methods. If it is not practicable to estimate the fair value of a particular financial instrument, disclose in the footnote the pertinent characteristics of the instrument and the reason for impracticability of setting a fair value (i.e., it would be excessively expensive to estimate).

Federal credit unions must provide fair value information on the quarterly/semiannual NCUA Call Reports. Include fair value information on the statement of condition as management and the independent auditing firm agree (i.e., if you are seeking an unqualified opinion).

### **OPTIONAL STATEMENTS**

The following statements are optional for credit unions under \$10 million. Post these statements with the required statements if management prepares them. Prepare the first two on a quarterly basis or at the end of the regular share account dividend period (if the dividend period is longer than quarterly). Prepare a Statement of Cash Flows at least annually:

- Statement of Members' Equity,
- Statement of Other Comprehensive Income (can be combined with Statement of Equity), and
- Statement of Cash Flows.

#### **Statement of Members' Equity**

This statement and notes thereto should show changes in total earnings during the period reported. At management's option, prepare this statement quarterly or at the end of the regular share account dividend period (if the period is longer than quarterly) and present it with other financial statements.

**Statement of Other Comprehensive Income** (can be combined with Statement of Equity)

Credit unions with more than \$10 million in assets may complete this statement quarterly or at the end of the regular share account dividend period (if the period is longer than quarterly) and present it with other financial statements. Management prepares this statement to report a measure of all changes in equity resulting from recognized transactions and other economic events of the period other than transactions with owners in their capacity as owners. This statement must accomplish two objectives:

- a) Classify items of Other Comprehensive Income by their nature in a financial statement; and
- b) Display the accumulated balance of Other Comprehensive Income separately from Retained Earnings and Additional Paid-in Capital in the equity section of a Statement of Financial Condition.

Other Comprehensive Income is total non-owner changes in equity during a period from transactions and other events and circumstances. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

#### **Statement of Cash Flows**

This statement provides relevant information about cash receipts and cash payments during the reporting period and supplements the Statement of Financial Condition and the Statement of Income. At management's option, prepare the Statement of Cash Flows at least annually under the accrual basis of accounting. Management may prepare the statement more frequently. Federal credit unions not using the accrual basis of accounting may prepare this statement.

The Statement of Cash Flows, when used with the related disclosures and other financial statements, should help to assess:

- a) Management's ability to generate positive future cash flows;
- b) Management's ability to meet its obligations, pay dividends, and determine its need for external financing;

c) Reasons for differences between net income and associated cash receipts and cash payments; and

d) Effects on the credit union's position of both its cash and non-cash investing and financing transactions during the reporting period.

More information pertaining to the Statement of Cash Flows, and its preparation and illustrations are found in Section 900 of this manual.

### **FULL AND FAIR DISCLOSURE REQUIRED**

The financial statements described above shall provide full and fair disclosure of all assets, liabilities, appropriations, and retained earnings. A limited number of valuation allowance accounts may be necessary to fairly present all income and expenses and the overall financial position for the reporting period.

### **FULL AND FAIR DISCLOSURE DEFINED**

"Full and fair disclosure" is the level of disclosure a reasonable person would provide to a member of a credit union, a creditor, or the NCUA in order to fairly inform them of the financial condition and the results of operation. Management provides full and fair disclosure by preparing financial statements consistent with this accounting manual or GAAP as long as GAAP is not inconsistent with regulatory requirements.

### **REQUIRED CERTIFICATION**

When presenting financial statements to members, creditors, and the NCUA, include a declaration by the treasurer and the president that the report is true and correct to the best of their knowledge and belief, and presents fairly the financial position and the results of operations for the reporting period. In the absence of the president, any other officer designated by the board of directors may make such declaration.

## **DEFINITIONS OF TERMS** (presented alphabetically)

Unless the context requires otherwise, the following terms have the meaning indicated in this section:

**Accrual Basis of Accounting** matches financial statement recognition with the period of occurrence. Under this basis of accounting, management records income when earned and expenses and liabilities as incurred regardless of the actual receipt of payment or disbursement.

**Accrued Interest** refers to Interest earned on loans, investments, or notes or mortgages payable, which has not been received or paid by the credit union. Management may accrue interest periodically on a time period consistent with the financial statements.

**Amortization** refers to the systematic write-down of prepaid and deferred expenses over a predetermined period of time, such as the write-down of an insurance premium or bond premium.

**Collateral** refers to real or personal property pledged as partial or full security on a debt including completed documentation for repossession and sale of the collateral in the event of default. A co-maker may be accepted in lieu of collateral to further secure a debt.

**Composite Depreciation Basis** refers to depreciating a group of fixed assets using a rate based on the estimated average useful lives of the assets. No depreciation is recorded when the accumulated depreciation allowance equals the book value of the fixed assets.

**Deferred Charge or Deferred Expense** refers to an expenditure not recognized as a cost of operations during the period incurred, it is carried forward and written off in one or more future periods. Often it includes prepaid expenses such as insurance premiums, stationery, and office supplies.

**Deferred Credit** refers to revenue or income received or recorded before it is earned. It includes income held in suspense until:

- Determination and deduction of offsetting charges,

- Completion of a period of time (such as collection of a related doubtful receivable), or
- Identification occurs.

**Donated Equity** is a regulatory accounting term that refers to equity in a credit union arising from contributions of real or personal tangible property (fixed assets).

**Appropriation for Loss Contingencies** refers to an appropriation of accumulated earnings set aside for possible decreases in the book values of assets or other undetermined liabilities not otherwise reflected on the books. Establish contingency appropriations as a precautionary measure only and include as a part of equity, as they represent isolations (appropriations) of undivided earnings.

**Undivided Earnings** refers to accumulated post-closing accumulated net income after distributions to members, adjustments affecting prior period operations, appropriations required by law, and appropriations authorized by the credit union board.

**Valuation Allowance** refers to an account representing management's judgment as to possible loss or decline in value within a specific class of assets such as loans or fixed assets.

**Modified Cash Basis of Accounting** refers to a blend of the cash basis of accounting and the accrual basis of accounting. It is a form of accounting based on actual receipts and disbursements and includes provisions for:

- a) Liabilities not paid when due;
- b) Unpaid dividends and interest refunds applicable to the accounting period;
- c) Deferred credits and charges applicable to future periods;
- d) Estimates of anticipated losses on loans outstanding and other risk assets; and
- e) Depreciation of fixed assets.