Accounting Norms and Principles

January 7, 2003

The purpose of an accounting system is to provide credit union management with complete and accurate financial information that can be used to operate the credit union safely and effectively. Accounting effectiveness is enhanced with the use of accepted accounting principles that address day-to-day credit union operations including:

- proper methods for handling member's transactions;
- accurate recording or transactions in the books and records;
- proper receipt and disbursement of funds; and
- preparation of financial statements in a manner that reflects the current financial position.

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 reveal the true financial condition of the credit union.

Monetary Basis for Accounting – Credit union accounts should be stated in terms of the monetary amount or value as of the transaction. The recording of each transaction in terms of monetary units provides the best feasible indicator of its relative impact on the overall operations of the credit union.

Materiality – A statement, fact, or item is material if, after giving full consideration to the surrounding circumstances, it would likely influence or "make a difference" in the judgement and conduct of a reasonable person. Material facts relating to financial activity should be recognized in credit union accounting and the resulting financial statements. The accumulation of many small items, each of which in itself would be immaterial, would be material if the overall effect would tend to influence the judgement and conduct of a reasonable person.

Accounting and Dividend Periods – Credit union accounting periods may be monthly, quarterly, semi-annually, or annually. The credit union may select the period length and close its books accordingly, but all credit unions should be required to close their books no less than annually. Share dividends are usually paid at the end of an accounting period, however, provisions should be made for regulatory reserve requirements and adjustments made to allowances for asset losses prior to any payment of dividends on shares.

Double Entry Accounting System – All 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 credits should be the same. In other words, for every debit entry there must be an equal offsetting credit entry and vice versa, if this is not the case the records will not balance.

The use of debits and credits can be very confusing to an individual with little accounting experience; to make accounting easier there are some basic rules that can always be followed:

- Asset accounts normally have debit balances, although at times such an account may have a credit balance.
- Liability accounts, including member savings and deposit accounts, normally have a credit balance, although at times the accounts may have a debit balance.
- Institutional capital and membership share accounts usually have credit balances, but like the liability accounts they may have a debit balance on occasion.
- Income accounts should have credit balances and, both operational and dividend expense accounts should have debit balances, although both income and expense accounts may have opposite balances from time to time.
- In other words, debits represent an increase of an asset, a reduction of a liability or capital account, or the payment of an expense. A credit represents a reduction of an asset, increase of a liability or capital account, or receipt of income.

Whether to debit or credit an account can be determined by the following guidelines:

- To increase an account that normally has a debit balance, it should be debited;
- To increase an account that normally has a credit balance, it should be credited;
- To decrease an account that normally has a debit balance, it should be credited; and
- To decrease an account that normally has a credit balance, it should be debited.

To ensure that the correct entry is made when preparing accounting entry, the accountant should answer the following questions:

- What are the account numbers and names that will be affected by this transaction?
- Do the accounts normally have a debit or credit balance?
- Is the account balance to be increased or decreased with the entry?
- How does the entry affect the financial statements?

Accounting for Transactions – The record of original entry or the Journal and Cash Record (JCR) is a diary of the transactions as they occur. Each day's cash receipts and disbursements are entered into the JCR in chronological order. Thus, a running history of each day's transactions is kept and may be summarized as needed.

At the end of a designated period, usually month-end, the total of all transactions for each account should be obtained by totaling the debit and credit columns of the JCR. The debit entries should equal the credit entries.

The record of final entry or the General Ledger as it is most commonly known serves as a means of summarizing the entries in a form that will enable the accountant to prepare reports on the results of operations as of month end and year to date. Entries in the general ledger consist of posting the debits and credits for each account in the JCR to the corresponding account in the general ledger and computing the net balance for each account. No entries should be made in the general ledger without first being made in the JCR.

When a general ledger account summarizes a number of transactions an additional record known as a subsidiary ledger should be used to provide detailed information about the general ledger account. Subsidiary ledgers are used to support general ledger accounts as they detail all of the entries made when more than one item is accounted for in the general ledger account. Subsidiary ledgers should be independent (bank statements, investment statements, etc.) from the general ledger. Subsidiary ledgers are used to verify that the general ledger balances are correct. If there is a difference between the general ledger balance and the subsidiary ledger then a reconciliation of the difference should be performed to identify the entries that make up the difference. The reconciliation should be retained with the subsidiary and general ledgers. A subsidiary ledger has many advantages including:

- isolation for a member, on a single ledger card, the transactions that effect their loans, savings, and share accounts;
- elimination from the general ledger of a great amount of detail relating to assets, liabilities, and capital accounts;
- easier location of errors by detailing individual entries that may be grouped or summarized in the general ledger account; and
- assistance to the accountant and the internal and external auditors in verifying the correctness of the general ledger balances and the financial statements.

For example – The general ledger account for depreciation of furniture, fixture, and equipment usually has one monthly entry summarizing all of the monthly depreciation amounts. Subsidiary ledgers are necessary for each piece of furniture or equipment. Each item accounted for was likely purchased on a different date and the purchase prices varied; therefore, the depreciation time frames and the amounts are different as is the outstanding balance of each depreciable item.

Financial Statements – Financial statements consist of two principal reports, the balance sheet and the income statement. The balance sheet summarizes the credit union's financial position as of a point in time. It is similar to a snapshot in that the balance sheet changes immediately after that point in time or the next business day. Normally the balance sheet is prepared as of the last day of each month.

The balance sheet lists the assets, liabilities, and capital accounts along with their outstanding balances as of month end. Assets are items of value that the credit union owns such as: loans, cash, investments, buildings, furniture, and equipment.

Liabilities represent amounts owed by the credit union to persons or legal entities. Typical examples of such items include: accounts payable, external credit payable, taxes, interest on member deposits, and accrued expenses. The liability side of the balance sheet also contains the member savings, ownership shares, and capital accounts.

The total of the asset accounts on the balance sheet should always equal the sum of the liability and capital accounts. If this is not the case, there is an error(s) as the credit union accounting records are not in balance.

The income statement reflects the gross amount of income earned and the total amount of expenses incurred during the period and allows users to determine if the credit union made a profit. If gross income is greater than the total of expenses and interest paid, the difference represents a net gain from operations during that particular period and is reflected as an increase in the undivided earnings account when the accounting records are closed. If the expenses and interest paid are greater than gross income, a loss is incurred and the undivided earnings account decreased as is institutional capital. The net gain or income after all expenses, interest on member deposits, and regulatory requirements have been met is available for payment on ownership shares.

At the end of the accounting period all income and expense accounts are closed and the balances are transferred to the net income account. The overall difference between gross income (credit balance) and total expenses and interest paid on member deposits (debit balances) also known as net income or loss is then closed and transferred to the undivided earnings account. Closing these accounts is necessary to reduce the income statement account balances to zero so these accounts can be used to collect revenue and expense transaction data for the following accounting period. Closing accounts at the end of an accounting period does not occur with balance sheet accounts. Balance sheet accounts collect transaction data throughout the life of the credit union, not just the accounting period.

Principles Effecting the Recording of Assets, Liabilities, Savings, Shares, and Institutional Capital as to Provide for Full Disclosure - Full and fair disclosure is defined as the level of disclosure a reasonable person would provide a credit union member to fairly inform them of the financial condition and the operational results of a credit union.

The financial statements described above should provide full and fair disclosure of all income, expense, assets, liabilities, savings, shares, and institutional capital accounts. Valuation or allowance accounts are usually necessary to present fairly the credit union's financial position.

The accounting principles relating to assets for a credit union using accrual-based accounting are as follows:

1. **Assets** are considered to be something of economic value that are used to satisfy the wants and needs of the members. Assets are normally recorded at their cost to the credit union. If an asset is no longer considered valuable such as, a borrower can not repay their loan or some equipment becomes obsolete, then the asset should be written off or removed from the balance sheet immediately.

2. **Loans Outstanding** should be recorded to reflect their unpaid balances as of the date of the financial statement.

3. **Accounts Receivable** represents amounts owed to the credit union by members, creditors, or employees. They are recorded to reflect their unpaid balances.

4. **Allowance for Loan Losses** represents all known and potential loan losses. This is a contra asset account, which means the account has a credit balance instead of a debit balance as asset accounts normally have. The effect of this contra asset account is to reduce the value of the loans outstanding by the amount of all potential loan losses. Monthly, management should determine that the allowance for loan loss account is adequate and meets any regulatory requirements. To avoid large adjustments to this account, the credit union should budget an amount (during the annual budgeting process) that will be expensed monthly through the provision for loan loss account (an expense account). This amount should be based on past losses, current delinquency, the economic situation, and regulatory requirements. If for some reason there is an unexpected large increase in the amount needed in the allowance for loan loss account, that amount should be expensed immediately, if it is not then the value of the loan portfolio will be overstated and the balance sheet not fully and fairly disclosed.

5. **Cash** (teller cash, vault cash, petty cash, credit union non-interest bearing checking accounts) is recorded as the amount of cash on hand at the credit union and in checking accounts as of the date of the financial statement.

6. **Investments** are recorded as the cost of the investment to the credit union. Under no circumstances are the values of investments written up to the current market value. If there is a significant decline in the value of the investment, then that decline should be recognized if the credit union will receive less at the investment maturity or the investment will be sold prior to maturity and result in a loss. If the investment is held to maturity, and the purchase value of the investment received, then a loss does not need to be accounted for. If the credit union is to recognize a loss it is done so with the **Allowance for Investment Loss account,** a contra asset account. The account has a credit balance. This account reduces the value of the investments by the potential loss. The offsetting or debit entry is to the provision for investment loss, an expense account.

7. **Fixed Assets** should be recorded in accordance with the following principles:
   - The purchase of fixed assets should be recorded at cost. The cost of acquisition is the net purchase price of the asset plus all incidental costs necessary to put the asset into use, such as freight, installation cost, etc. If property is exchanged for the acquired asset, then cost is recorded as the amount of cash paid plus the recorded amount of the asset surrendered. No gain, if any, should be recognized on the transaction; the entire indicated loss on the exchange, if any, should be recognized. If property is acquired through exchange without cost or a donation, the fair market value as of the date the asset is received should be used as the cost. With donations, the offsetting credit entry is to donated equity.
   - Each credit union's board of directors should establish a dollar value limit (for example $25USD or the equivalent in local currency) under which fixed assets will be recorded as a current expense instead of established as a fixed asset and depreciated.

8. **Depreciation** of credit union fixed assets is the charge allocated to an accounting period to distribute the cost of the fixed assets less salvage value (if any) over the estimated useful life of the asset. Depreciation is an equal amount that is expensed each month; it reduces the value of the asset as the asset is used. Depreciation is a contra account and therefore has a credit balance.
   - Fixed assets, whether purchased or donated, should be depreciated to a minimum amount or salvage value. They should not be removed from the general ledger or the credit union's inventory as long as they are in use. Assets that are depreciated to zero and no longer recorded in the accounting records can be easily removed from the premises since there is no longer any record.

9. **Prepaid Expenses** are costs of a material amount that effect subsequent accounting periods. These costs or expenses are amortized over the accounting periods to which they are applicable. For example, if a credit union has to pay association dues which cover one year's dues in the association during the 1st month of the year, then the accountant should establish a prepaid expense account and expense 1/12th of the expense each month throughout the year until the prepaid account has a zero balance. With this entry the credit union does not have a large expense during the 1st month of the year, the expense is evenly distributed throughout the time period for which the expense is attributable.

10. **Other assets** are all assets that do not fall in the above categories. They are to be recorded at cost.

11. An essential characteristic of a **liability** is that there is a present obligation and the settlement of the obligation will cause an outflow of credit union resources. **Liabilities** should be recorded at their actual amounts or, if the actual amounts are not known, they should be recorded based on reasonably accurate estimates.

12. **Accounts Payable** consist of all bills that have been received and are due for payment but as of the date of the financial statement remain unpaid. The invoice amount is the amount recorded in the books.

13. **External Credit Payable** represents all borrowed funds. The amount recorded is the outstanding amount payable.

14. **External Credit Interest Payable** is the amount of interest that is due on the external credit. The interest due as of the financial statements should be accrued for; the amount payable is all accrued interest since the last interest payment made.

15. Interest on member deposits that have a stated or contracted interest rate are to be accrued for in **Accrued Interest on Deposits**. Members usually sign a contract when making these deposits that states a certain amount of interest will be received for the deposit. Because of the contract, the member must always receive the interest amount

described in agreement. The accrual is based on the stated rate in the agreement. Interest on deposits should be accrued no less than monthly.

16. **Accrued Expenses** allocate costs to the periods benefited. These expenses are estimable, based on past history, and should be accrued monthly. For example - A credit union has their annual meeting in September each year. To account for this type of expense an amount should be accrued monthly that is $1/12^{th}$ of the amount anticipated to be spent (from October of the previous year to September of the current year). With this accounting the net income remains level throughout the year instead of a large expense in September when the meeting is held.

17. **Contingent Liabilities** are defined as an existing condition, situation, or set of circumstances that may or may not result in a loss for the credit union. The amount of the loss will be determined by future events. Examples of contingent liabilities include pending or threatened litigation, guarantees of the indebtedness of others, and agreements to repurchase assets that have been sold. The amount of a contingent liability should be accrued for if:
    - prior to the issuance of the financial statements it is probable that a loss will actually occur; and
    - a reasonable estimate of the resulting loss can be made.

18. **Member Deposits** are recognized in the accounting records at the actual amount deposited. Numerous types of deposit accounts are usually offered including: demand deposit accounts, term deposits of various maturities, special purpose savings accounts, retirement accounts, checking accounts, and hi-yield or money market accounts.

19. **Net Income** is the difference between all income, expense, and interest paid on external credit and member deposits for the current accounting period. Net income is considered a part of institutional capital.

20. **Capital** can be divided into two types, **institutional and equity capital.** **Institutional capital** is defined as the total of regulatory reserves, undivided earnings, special reserves (designated for a specific purpose), monetary donations, and net income. These capital accounts can be used for losses and no party or individual has any claim to these funds as they belong to the credit union. Ownership shares are **equity capital.** These shares are withdrawable upon membership termination and frequently can be used to secure loans. The credit union does not have sole claim to these shares, therefore it is not the rightful owner of the shares. Ownership shares may be used to absorb losses, if they are considered as the member's liability, but frequently are not available because they are securing member loans. Effectively these borrowers have withdrawn their shares in the form of a loan.

21. **Undivided Earnings** is a part of institutional capital; past net income and losses are accumulated in this account. At the close of each accounting period, the income and expense accounts should be closed to the Net Income/(Loss) account, after which the

balance of the Net Income/(Loss) account should be transferred to Undivided Earnings. Other miscellaneous charges should be made to undivided earnings only for correction of an error of a material amount that represents adjustments affecting prior accounting periods. Material errors include: arithmetic mistakes, the misuse or deletion of information, mistakes in the application of accounting principles or procedures, and improper interpretations of the accounting aspects of major transactions. Correction of an error should result in the restatement of the prior year's financial statement to disclose the effect of the correction made.

22. **Capital Reserves** are the capital reserve accounts required to achieve capital adequacy. Credit unions should not be permitted to pay dividends on ownership shares prior to meeting all regulatory requirements. Regulatory reserves are a part of institutional capital.

23. **Donated Equity** is the account used to record a gift or donation of a tangible fixed asset of material value. The value of such an asset should be established by a credit to this account and the offsetting debit is to the appropriate asset account such as furniture and equipment. When fixed assets donated to a credit union are not considered material in value, the credit would be to non-operating income instead of donated equity and the debit either to an asset or expense account depending on the purpose of the donation. Only monetary donations are considered institutional capital.

24. **Asset Revaluation Accounts** are used to reevaluate fixed assets due to serious inflation. The appropriate fixed asset accounts are increased or debited, based on an appraisal, to recognize the effects of inflation and the reevaluation equity account is credited. Asset reevaluation accounts are not considered part of institutional capital as the account has no monetary significance, it is only an accounting adjustment.

25. **Ownership Shares** are classified as equity capital on the credit union's balance sheet. They are not considered to be a part of institutional capital. Ownership shares are accounted for at the actual amount of the deposit made by the member. Shares may be used to absorb operational credit union losses. Member liability is frequently limited to the amount invested in ownership shares. Each member must have the minimum amount in ownership shares to access all credit union services. Shares can be paid a dividend only after operating expenses, interest on deposits and regulatory capital requirements have been made. Dividends paid may be added to the share account balance or paid out to the member.

Principles Effecting the Recording of Income and Expenses as to Provide for Full and Fair Disclosure - All income, expenses, gains, and losses affecting an accounting period should be recorded in the appropriate income and expense accounts. Income and expenses from regular operations should be separated from extraordinary gains or losses occurring during the accounting period to enhance disclosure.

1. **Income** includes both revenues and gains. Revenue or income arises in the course of ordinary credit union activities and gains arise from non-operational or unusual occurrences. Income accounts normally have a credit balance. Income should be accrued for when earned but not yet received as of the date of the financial statement. The entries to recognize income are to accrued income on loans or investments (debit) and interest on loans or investments (credit). Fees and late charges should be recorded as income when received.

2. **Expenses** include losses as well as other expenses that arise in the course of ordinary credit union operations. Normal operating expenses include: employee salaries and benefits, association dues, rent, utilities, stationary and supplies, loan processing expenses, travel and entertainment expenses, repairs and maintenance, postage, publications, communications, advertising, professional and outside services, teller cash overages and shortages, interest on external credit and interest on member deposits. Expenses relate to current operations and should be paid and recorded promptly when due. If, however, at the end of the month there are invoices which are for expenses that have not been paid they should be recorded as current month expenses (debit) and to accounts payable (credit) until paid. Large expenses that are applicable to future periods should be recorded as prepaid or accrued expenses and amortized over the periods to which they are applicable, these include:
   - **Fixed Assets,** as discussed earlier, are depreciated monthly over the life of the asset through an expense account; and
   - **Prepaid and Accrued Expenses** are included in expenses monthly through the amortization of prepaid expenses and accruals for costly future expenditures such as the annual meeting, annual audit, property taxes, etc.

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