FINANCIAL REGULATOR
Rialtóir Airgeadais

Guidance Note for Credit Unions on Matters Relating to Accounting for Investments and Distribution Policy

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Registry of Credit Unions

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Introduction

The board of directors of each credit union has a statutory responsibility under **Section 53 (1)** of the Credit Union Act, 1997 (as amended), ("the Act"), for the general control, direction and management of the affairs, funds and records of the credit union.

The board of directors of each credit union must ensure that they comply with the Accounts and Audit requirements set out in **Part VII** of the Act. In particular, proper **accounting records** should be kept to disclose the financial position of the credit union at any time and give a **true and fair view of the state of affairs of the credit union**. **Accounting policies** should be applied on a **consistent basis** and the **amount of any item in the accounts** should be determined on a **prudent basis**.

The role of investments in the financial structure of credit unions has become more significant in recent years and the range and type of such investments have become more complex. The Guidance Note on Investments by Credit Unions, issued by the Registrar of Credit Unions ("the Registrar") in October 2006, specified the authorised classes of investment instruments and the limits attaching to each class of investment from that date. Significant losses have been incurred on some investment products notably perpetual bonds, the central treasury managed fund and equity-based products. An added concern is the variety of accounting treatments used by credit unions in valuing investments and in recognising and distributing income accruing on such investments (in the form of dividends). The Registrar is of the view that some of these accounting practices may pose risks to the financial stability of credit unions.

Section 84 of the Act, requires the Registrar to administer the system of regulation and supervision of credit unions with a view to the protection by each credit union of the funds of its members and the maintenance of the financial stability and well being of credit unions generally.

Accordingly, this Guidance Note is being issued to remind credit unions to ensure that the accounting treatment which they adopt for investments complies with the relevant requirements of the Act and that their distribution policy is appropriate and prudent for the particular circumstances of the credit union.

Credit unions will be subject to inspection from time to time to assess their compliance with this Guidance Note.

1. Accounts and Audit Requirements of the Credit Union Act, 1997 (as amended)

1.1 **Section 53 (1)** of the Act states that the board of directors of a credit union shall have responsibility for the general control, direction and management of the affairs, funds and records of the credit union.

1.2 **Section 108** of the Act requires that every credit union shall keep proper accounting records on a continuous and consistent basis. In accordance with this section of the Act such records shall disclose with reasonable accuracy and promptness the financial position of the credit union at any time, give a true and fair view of the state of affairs of the credit union and explain its transactions.

1.3 **Section 109** of the Act requires credit unions to operate systems of control and safe custody of accounting and other records.

1.4 **Section 110 (1)** of the Act sets out the accounting principles that apply when determining the amount to be included in the accounts of a credit union. These principles include:

- **Accounting policies shall be applied consistently** from one financial year to the next.
- The **amount of any item** in the accounts shall **be determined on a prudent basis** and in particular:
  - **only surpluses realised** at the balance sheet date shall be included in the income and expenditure account and
  - **all liabilities and losses which have arisen or are likely to arise** in the financial year to which the accounts relate, or the previous financial year, **shall be taken into account** including those liabilities and losses which only become apparent between the balance sheet date and the date on which the accounts are signed.

Section 110 (2) of the Act states that, if it appears to the board of directors of a credit union that there are special reasons for departing from any of the principles specified in Section 110 (1) of the Act, they may so depart **but particulars of the departure, the reasons for it and its effect on the balance sheet and income and expenditure account shall be stated in a note to the accounts, for the financial year concerned.**

1.5 **Section 111** of the Act sets out the requirements in relation to **"annual accounts"**. It includes requirements for the directors of a credit union to prepare, with respect to each financial year: (a) an income and expenditure account and (b) a balance sheet, giving a true and fair view of the income and expenditure for the year and the state of its affairs at the end of that year. Each of these items shall be in such form and shall contain such particulars as the Registrar may direct.

1.6 The Act also sets out a range of requirements in relation to **auditors** of credit unions. **Section 113** of the Act sets out the obligation to appoint auditors. **Section 118** of the Act sets out the requirements in relation to resignation of auditors. **Section 118 (2)** of the Act requires the auditor to send a copy of a notice of resignation to the Registrar at the same time that it is sent to the credit union.

1.7 **Section 120** of the Act sets out the details that should be contained in **the auditor's report** including the requirement to report on whether the credit union's annual accounts have been properly prepared so as to conform with the requirements of the Act and give a true and fair view of the state of affairs of the credit union at the financial year–end and of the income and expenditure of the credit union for the financial year.

1.8 **Section 122** of the Act sets out the auditor's duty to report certain matters to the Registrar[1]. These duties include reporting where the auditor has reason to believe that (1) there exist circumstances which are likely to affect materially the credit union's ability to fulfil its obligations to its members or meet any of its obligations under the Act or (2) there are material defects in the accounting records, systems of control of the business and records of the credit union.

1.9 The board of directors of credit unions should be aware that the auditor, in accordance with **Section 122 (1) (d)** of the Act, shall inform the Registrar where the auditor proposes to qualify any report, which is provided under the Act.

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[1] Section 27B of The Central Bank Act, 1997 (as amended) ("the CBA 1997") as inserted by Section 26 of the CBFSAI Act, 2004, imposes a similar obligation on auditors (including auditors of credit unions) to make such reports to the Registrar. In addition, Section 27C of the CBA 1997 applies to auditors of credit unions and requires that if an auditor provides a report on specified matters, to the credit union, a copy must also be provided to the Registrar. Where no such report is provided to the credit union the auditor must notify the Registrar that such is the case.

2. Accounting Policies

2.1 The board of directors of each credit union should adopt accounting policies that are appropriate to its circumstances for the purposes of ensuring that its income and expenditure account and balance sheet give a true and fair view. The **accounting policies should be consistent with the requirements of the Act.**

2.2 The objectives against which the board of directors of a credit union should judge the appropriateness of accounting policies to its particular circumstances are the **requirements of the Act** in relation to **consistency and prudence.** The objectives[2] against which **accounting policies** should also be assessed include **relevance, reliability, comparability and understandability.**

2.3 The objective of annual accounts is to provide information about a credit union's financial performance and financial position that is useful for assessing the stewardship of the board of directors and for making business/financial decisions. Appropriate accounting polices will ensure that the financial information being presented is relevant.

2.4 Appropriate accounting policies will ensure that the financial information being presented is reliable. Financial information should be prudently prepared. This involves the application of a degree of caution in exercising judgement and making the necessary estimates. Often there is uncertainty, either about the existence of assets, liabilities, gains or losses, or about the amount at which they should be valued. The board of directors should consider whether market conditions could give rise to a risk of material misstatement.

[2] The Accounting Standards Board ("ASB") issued Financial Reporting Standard 18 on Accounting Policies which sets out the principles to be followed in setting accounting policies and the disclosures needed to help users to understand the accounting policies adopted and how they have been applied.

2.5 The usefulness of the annual accounts of a credit union is enhanced by transparency and consistency in the presentation of the information. This allows meaningful comparisons with similar information about the credit union for some other relevant period and point in time and with similar information about other credit unions.

2.6 **Section 110 (1) (b)** of the Act requires that accounting policies shall be applied consistently from one financial year to the next. Any departure from this accounting principle may only take place in accordance with the provisions of **Section 110 (2)** of the Act. **Such a departure should only occur in unusual and exceptional circumstances.** Where this occurs, the provisions of **Section 110 (2)** of the Act apply. Any changes in an accounting policy will have an impact on prior years' results and reserves and the board of directors should be aware of the implications of all such changes. There should be a note to the annual accounts explaining the impact of all such changes in accounting policies.

2.7 Appropriate accounting policies should result in financial information being presented in a way that enables its significance to be understood by the users of accounts.

3. Valuation of Investments

3.1 The accounting policy adopted by the board of directors of a credit union for the valuation of investments should comply with the relevant sections of the Act, in particular **Section 110.** This section requires that the **amount of any item** in the accounts shall be determined on a **prudent basis** and in particular that **all liabilities and losses** which have **arisen or are likely to arise in the financial year** to which the accounts relate, or a previous financial year, **shall be taken into account** including those liabilities and losses which only become apparent between the balance sheet date and the date the accounts are signed.

3.2 It is recognised that under generally accepted accounting practice there are a number of different bases available for the valuation of investments. The Registrar is of the view that for the majority of credit unions, having regard to the nature of their operations and the requirements of the Act, **the lower of cost and net realisable value will usually be the most appropriate valuation method.**

3.3 Under this method the amount to be included in the balance sheet in respect of investments should be the lower of their cost or net realisable value. The amount of any write-down provided should be clearly shown in the income and expenditure account.

3.4 Where the circumstances for which any provision for diminution in value was made in accordance with paragraph 3.3 cease to apply, that provision should be written back to the extent that it is no longer necessary.

3.5 Where a credit union has adopted an accounting policy on valuation of investments other than the lower of cost and net realisable value, it should discuss its accounting policy with its professional advisors in the context of this Guidance Note in order to determine the appropriate course of action for current and future accounting periods.

3.6 Full and detailed disclosure of the accounting policy adopted for valuation of investments should be disclosed in the annual accounts.

4. Income Recognition

4.1 The accounting policy adopted by the board of directors of a credit union for the recognition of investment income should be in compliance with the relevant sections of the Act, in particular with **Section 110** which requires that the amount of any item in the accounts shall be determined on a **prudent basis** and in particular that only surpluses realised at the balance sheet date shall be included in the income and expenditure account.

4.2 In determining whether surpluses have been "realised" for the purposes of the Act, credit unions should review their investment income and gains for the year and discuss the proposed treatment with their professional advisors. Investment income and gains should be clearly shown separately in the income and expenditure account (or notes thereto) and should be analysed in accordance with the requirements set out in Section 5 – paragraph 5.4.

4.3 Full and detailed disclosure of the accounting policy adopted for income recognition on investments should be set out in the annual accounts.

4.4 Auditors are obliged to review the financial statements prepared by the board of directors and may express an adverse or qualified opinion if they disagree with the accounting policies, the method of their application or the adequacy of the disclosures selected[3].

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[3] International Standard on Auditing (UK and Ireland) 700 "The Auditor's Report on Financial Statements" issued by the Auditing Practices Board.

5. Distribution Policy

5.1 **Section 45 (1)** of the Act states that a credit union shall establish a reserve ("statutory reserve") by allocating in respect of each financial year not less than 10 per cent of the surplus funds of the credit union for that purpose. **Section 45 (4)** of the Act states that, notwithstanding the provisions of **Section 45 (1)** of the Act, the board of directors may recommend to the members an increased allocation to the statutory reserve. Credit unions may also make allocations to other reserves in order to set aside amounts for the future.

5.2 In order to comply with the requirements of the Act in relation to distributions and reserves together with the requirement for prudence, each credit union should ensure that it makes adequate allocations to its statutory reserves and other reserves. In determining the appropriate level of reserves to be maintained, the board of directors of each credit union must comply with any regulatory requirements on reserves for credit unions issued by the Registrar. In addition, each board must take account of its particular circumstances as well as the prevailing market conditions. The impact of these factors on the performance of its loans and investments and on liquidity requirements should be fully assessed in determining the requirements for transfers to reserves and for setting a prudent level of distribution.

5.3 **Section 30** of the Act sets out the provisions in relation to dividends on shares. **Section 30 (3)** of the Act states that the maximum dividend payable is 10 per cent of the nominal value of shares of the credit union. **Section 30 (5)** of the Act states that no dividend on shares shall be paid otherwise than out of **(a) surplus funds in respect of the year in question which are available for that purpose after meeting the requirement for the statutory reserve or (b) a reserve set aside in previous years to provide for dividends.**

5.4 Investment income and gains should be separately analysed in the income and expenditure account (or notes thereto) as follows:

(i) Investment income and gains received by the credit union at the balance sheet date;

(ii) Investment income that will be received within 12 months of the balance sheet date;

(iii) Other investment income.

Any investment income, which **does not fall within the criteria set out at (i) or (ii)** should not be distributed and be transferred to a reserve, which is designated as not eligible for distribution, for so long as those amounts do not meet criteria (i) or (ii).

While amounts falling within criteria (i) and (ii) **may be considered as available for distribution**, any decision by the board of directors of the credit union on the actual distribution level for a particular year must be considered in the context of whether it is prudent to do so. In particular, in making an assessment on the amount of any distribution of income falling within **criteria (ii),** any **terms or conditions** attaching to the receipt of this income, such as a requirement to hold the investment until maturity before a return crystallises, must be taken into account. Where the circumstances are such that the credit union may need to break any of the terms or conditions attaching to the particular investment, no distributions of such income should be made until the income has been received.

5.5 Details of all reserves, together with the distribution policy, should be disclosed in the annual accounts.

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