



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Credit Union Auditor

By E-Mail

18 September 2014

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www.centralbank.ie

**Re: Auditing of the Annual Accounts of Credit Unions for the year ending
30 September 2014**

Dear Sir / Madam

The annual external audit is an important source of information relevant to our regulatory process. In making an assessment of the financial condition and performance of each credit union we rely heavily on the annual audited accounts and the independent opinion expressed by the auditor to the members.

Accordingly we are writing to all auditors of credit unions to outline particular areas for focus in respect of the financial year ending 30 September 2014.

The financial and operational environment for credit unions continues to be very challenging in 2014. Continued loan book contraction remains a significant cause of concern. As operating costs continue to rise, the pressure on net margins from falling loan interest income and declining investments returns has continued.

The new requirements of the Credit Union Act 1997 ("the 1997 Act") are designed to strengthen governance and the internal controls in credit unions. Auditors should be aware that boards of directors and managers should be focused on the implementation and embedding of the new regulatory framework. The requirement that all credit unions must have comprehensive strategic plans in place, has assisted some boards in highlighting challenges relating to on-going viability and the sustainability of their core business model. The embedding of the new functional roles of compliance officer, risk management officer and internal audit, which should be adequately resourced with experienced persons, are intended to support boards and management in discharging their fiduciary duties and responsibilities to credit union members.



1. The Credit Union Act, 1997 (“the 1997 Act”)

In accordance with the requirements of the 1997 Act auditors of credit unions have a statutory obligation to express an independent opinion to the members on the annual accounts and to report certain matters to the Registrar of Credit Unions (“the Registrar”). The 1997 Act governs the operation, management, control and supervision of credit unions and sets out the responsibilities of the boards of directors and other credit union officers.

1.1 Systems of Control

Section 109 of the 1997 Act requires credit unions to establish and maintain systems of control. The systems of control must ensure that the information necessary to enable the credit union and the auditor to discharge their respective functions is sufficiently accurate and is available with sufficient regularity and sufficient promptness. Auditors may need to consider whether there has been any failure in the credit union’s procedures for ensuring the effective operation of the systems of control.

Auditors are reminded that boards of directors of credit unions are required to have in place an independent internal audit function to evaluate and improve the effectiveness of the credit union’s risk management, internal controls and governance processes. The internal audit function should maintain open communication with the auditor. This should include a clear delineation of responsibilities, plans and procedures for co-operation to ensure effective audit coverage and to minimise duplication of effort. It would be expected that auditors would obtain a copy of any internal auditor reports. Auditors should also be aware of the requirements of the International Auditing Standard on using the work of internal auditors.

1.2 Accounting Principles

Section 110 of the 1997 Act sets out the accounting principles that apply when determining the amounts to be included in the annual accounts of a credit union. These include a requirement that the amount of any item in the accounts shall be determined on a **prudent basis** and that:



- 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.

1.3 Annual Compliance Statement

Auditors should be aware since 3 March 2014, all credit unions are required to submit an annual compliance statement to the Central Bank within two months of the end of the financial year of the credit union, i.e, by 30 November. Auditors are not required to express an opinion on a credit unions' annual compliance statement but they may wish to obtain a copy of that statement for the purposes of their understanding of the credit unions risk profile.

2. Duty to Report to the Registrar

Auditors are reminded of their duties under the 1997 Act and the Central Bank Act, 1997 to report certain matters to the Registrar. Details of these reporting requirements are set out in Appendix 1. Auditors are reminded that the Section 27B(2)(a) of the Central Bank Act 1997 report and the auditors "*management letter*" can only be submitted through the Online Reporting System.

The management letter from auditors is one of the key information mechanisms used in our regulatory process. The content of the management letters generally is variable in highlighting areas of significant concern about systems, control and related governance issues in credit unions. Our concerns about the quality and content of the management letters have been reinforced by our onsite PRISM engagements. Auditors should be aware of the findings contained in the "*Credit Union PRISM Risk Assessments Supervisory Commentary*"(May 2014)¹

¹ Available at www.centralbank.ie



from the first cycle of risk assessments and on-site engagements with credit unions, which identified fundamental weaknesses in governance, lending, operations and risk management functions in many credit unions.

Weaknesses in credit unions lending, credit control and credit risk management standards and practices were also identified. Auditors are reminded of the importance of management letters to both credit unions and the Registry of Credit Unions. In this regard we would expect to see an improvement in the reporting of significant issues that come to the attention of auditors during the course of the audit of credit unions.

3. Year-end Approach – 30 September 2014

A circular, dated 17 September 2014 was sent to the chair of each credit union which highlighted the key areas on which the board of directors should focus for the 2014 year-end, including the impact of any proposed distribution to members. This circular, a copy of which is attached to this e-mail, should be considered by auditors in carrying out their audit work.

4. Regulatory Reserve Ratio

It is vital that credit unions maintain adequate levels of overall reserves and provisions to ensure they remain financially stable. In particular, auditors are reminded all credit unions are required to maintain a Regulatory Reserve Ratio² of not less than 10 per cent.

Auditors should also be mindful of the impact of any proposed distributions, by boards of directors of credit unions to members, on the financial stability of the credit union.

5. Asset Valuation

A particular area of regulatory focus for the Registry of Credit Unions will continue to be on the appropriateness of asset valuation and methodology selected by credit unions to arrive at such

² Regulatory Reserve Ratio for Credit Unions – August 2009: available at www.centralbank.ie in the Credit Union Handbook chapter on Reserves.



valuations. Where credit unions have received an asset review report from this office, or have been required to commission independent asset reviews, a copy of any such reports should be obtained from the credit union and considered fully by the auditor.

5.1 Loan Provisioning

As part of the year-end audit, auditors should take into consideration the level of risk inherent in the full loan book, with particular emphasis on the adequacy of the bad debt provisions.

We expect directors of credit unions to apply a conservative and realistic approach in the measurement of bad debt provisions. Whilst we recognise the responsibilities of directors to prepare the accounts of the credit union, we expect auditors to exercise “*professional scepticism*” when auditing the level of bad debt provisions contained in the annual financial statements and to take into account the skills and expertise of boards and management of the individual credit union.

In this regard we draw auditors’ attention to *Practice Note 27(I) (The Audit of Credit Unions)* and in particular to the section dealing with the audit of accounting estimates. As part of the reasonableness review of loan provisions auditors should ascertain that the directors have properly exercised their judgement, followed a consistently applied policy and have not merely followed a standard formula / matrix calculation. In forming an opinion on the adequacy of the bad debts provisions determined by the directors, auditors need to be mindful of practices that can have the effect of understating provisions. Such practices include loan rescheduling, temporary loan arrangements, top-up loans, single/lump sum repayment loans, bullet type repayment loans, interest only loans, connected party loans and share to loan transfers. Auditors should also consider the adequacy of the security attaching to loans where this has been taken into account by the directors in determining the level of bad debts provision in the accounts.

We expect that credit unions as part of the year end and quarterly loan book reviews process in assessing the adequacy of loan provisions to undertake a detailed review of top-up type lending



where the overall level of individual member debt over a period of time remains broadly unchanged or is increasing. Credit unions should be mindful that excessive top up type lending to members can have the effect of solidifying member's core debt and where there is evidence of such trends, adequate provisions consistent with the increased risk profile should be made against such loans. It would be expected that auditors would obtain a copy of any such reviews.

Auditors should be aware that Section 35 Regulatory Requirements requires credit unions to undertake a full review of the bad debts provisions, including provisions held against rescheduled loans, as part of the year-end accounts preparation and audit process. Auditors should determine the scope of the audit work required to satisfy this requirement.

5.2 Accounting for Investments and Distribution Policy

Credit unions need to continue to maintain adequate levels of liquidity for their own particular circumstances and must comply with all legislative and other requirements issued by this office. In assessing the adequacy of liquidity this should be consistent with the credit unions risk appetite taking account of the funding profile of the balance sheet, in particular members' savings profiles and other issues to determine an adequate buffer is calculated to avoid inadvertent breaches of the minimum regulatory liquidity requirements. It is expected that auditors to credit unions would obtain a copy of their credit union's liquidity risk appetite.

In developing the risk appetite credit unions need to ensure that it is consistent with the circulars on the *Guidance Note for Credit Unions on Matters Relating to Accounting for Investments and Distribution* (April 2009), "*Credit Union Liquidity and Investments*" (February 2011), "*Guidance Note on Investments by Credit Unions*" (June 2011), and the "*Amendment to the Guidance Note on Investments by Credit Unions, October 2006*" (February 2013) "*Investments in State Securities (other than Irish State Securities)*" (December 2013).³ Auditors are reminded that the directors in preparing the 2014 annual accounts should take into consideration the

³ These guidance notes are available at www.centralbank.ie in the Credit Union Handbook chapter on Investments.



*Guidance Note for Credit Unions on Matters Relating to Accounting for Investments and Distribution Policy*⁴.

In particular, directors of credit unions are required to ensure that the accounting treatment for investments complies with the relevant requirements of the 1997 Act and are in accordance with the Guidance Note relating to the valuation of investments and that the distribution policy is appropriate and prudent. Auditors are reminded of the directors' obligations in this area.

Credit unions have been reminded that, in accordance with the June 2011 circular on "*Guidance Note on Investments by Credit Unions*," investments in a single institution should not exceed 25 per cent of the total value of a credit union's investment portfolio.

5.3 Impairment of Fixed Assets

In accordance with Financial Reporting Standard 11 (Impairment of Fixed Assets and Goodwill) ("FRS 11") credit unions should carry out a review for impairment of fixed assets if events or changes in circumstances indicate that the carrying amount of the fixed asset may not be recoverable.

Where circumstances indicate that there is an impairment review required and the directors have adopted a "value in use" approach, auditors should consider the appropriateness of the underlying assumptions used in deriving the expected cash flows to ensure that the assumptions are reasonable and supportable. Where a value in use approach has previously been adopted subsequent monitoring of cash flows should be carried out by the credit union in accordance with FRS 11.

Auditors should be aware that in some credit unions where directors are applying a value in use approach it is creating an illusion of capital strength when underlying market values of property assets are far lower than the carrying values. The value in use calculation should be supported by

⁴ Guidance Note for Credit Unions on Matters Relating to Accounting for Investments and Distribution Policy – April 2009: available at: www.centralbank.ie in the Credit Union Handbook chapter on Investments.



realistic assumptions aligned with financial projections derived from achievable and realistic business objectives and business activity levels which are consistent with the credit unions strategic plan.

6. Correspondence issued to credit unions by the Registry of Credit Unions

As part of the year end audit, auditors should obtain from the credit union a copy of all correspondence issued from this office, including where relevant any regulatory directions/requirements issued.

Auditors should also be aware of issues arising from our engagement with credit unions through the PRISM process. Auditors should obtain copies of any Risk Mitigation Programmes or other requirements, including those relating to asset reviews, which have been issued to credit unions as part of our engagement process. In particular auditors should obtain from credit unions details of all outstanding Risk Mitigation actions.

Auditors should be aware that Section 76A of the 1997 Act requires all credit unions to have a strategic plan incorporating three year financial projections and the auditor should obtain a copy of the plan from the credit union.

7. Annual Accounts

Section 114(4)(c) of the 1997 Act requires that a credit union shall not publish, for any financial year, any income and expenditure account, balance sheet or statement unless it has been signed:

- *by the manager of the credit union;*
- *by a member of the board oversight committee acting on behalf of that committee; and*
- *by a member of the board of directors acting on behalf of the board.*



8. Resignation of Auditors

Auditors are reminded of the requirements to notify this office pursuant to Section 118 of the 1997 Act where they intend to resign as auditor.

9. Information Point – Legislative Changes

For information purposes, auditors should be aware that there have been significant legislative changes during 2013 and 2014 with the commencement of new legislation which are impacting on the sector.

Legislative changes during 2013 and 2014 include the following:

- Credit Union and Co-operation with Overseas Regulators Act 2012;
- Central Bank (Supervision and Enforcement) Act 2013;
- Personal Insolvency Act 2012.

For credit unions with assets of greater than €10 million the fitness and probity requirements have been fully implemented and apply from 1 August 2014 for all controlled functions. Further details were set out in the “*Credit Union News*” (July 2014).

With effect from 3 March 2014 all credit unions are required to have a board of directors with 7, 9, or 11 members in accordance with Section 53(3) of the 1997 Act.

In addition the board oversight committee is required to report to the members at the annual general meeting or special general meeting on whether the board has acted in accordance with the specified provisions of the 1997 Act.

10. Planning by Credit Unions and Auditors for the Implementation of the New Financial Reporting Standard 102

Adoption of Financial Reporting Standard 102 (the “Standard”) is mandatory for year-ends beginning on or after 1 January 2015. All credit union accounts for year-end 30 September 2016



will be required to be prepared under this Standard with restatement of 2015 comparatives also required at that time (i.e. for accounting periods commencing 1 October 2014).

While mandatory adoption is not required until year ended 30 September 2016 credit unions should now plan for the implementation of the new Standard. In particular auditors should engage with their credit union to ensure that they identify the necessary steps and actions required, so that they are adequately prepared for transition to this Standard in accordance with the relevant timelines.

The Registry of Credit Unions intends to engage with the sector stakeholders including the accountancy bodies on this matter and will provide further updates to credit unions on regulatory aspects arising.

The Standard can be accessed on the Financial Reporting Council website.

Finally, if you have any queries on the above please contact Martin Johnson in this office on (01) 224 4202 or by e-mail at martin.johnson@centralbank.ie.

Yours faithfully,

A handwritten signature in blue ink that reads "Anne Marie McKiernan".

Anne Marie McKiernan
Registrar of Credit Unions

Appendix 1

Credit Union Act, 1997 and the Central Bank Act, 1997

Summary of Duties of Auditors to report certain matters to the Registrar of Credit Unions

Section 122 of the Credit Union Act, 1997 sets out the auditor's duty to report certain matters to the Registrar. These duties include reporting where the auditor has reason to believe that:

- (1) there exists 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; or
- (3) proposes to qualify any report which is provided under the Credit Union Act 1997. Auditors are reminded that where they have provided a report ("management letter") to a credit union on a matter that has come to their attention during the course of the audit a copy should also be provided to the Central Bank.

Section 27B of The Central Bank Act, 1997 also imposes obligations on auditors to make reports (the "Statutory Duty Declaration") to the Registrar. The Statutory Duty Declaration must be submitted within one month after the date of the auditor's report on the credit union accounts stating whether or not circumstances have arisen that require the auditor to report to the Registrar. Auditors of credit unions must submit the Statutory Duty Declaration annually. Failure by auditors to comply with Section 27B of the Central Bank Act, 1997 is an offence.

Practice Note 27(I) provides further useful background commentary on the duties of auditors of credit unions to report to the Registrar.

Appendix 2

The Electronic Submission of reports by auditors of credit unions pursuant to the provisions of Sections 27B (2) (a) of the Central Bank Act, 1997 and Section 122 of the Credit Union Act, 1997 for the year ended 30 September 2014

For the year ending 30 September 2014 RCU require auditors of credit unions to submit electronically the Section 27B (2) (a) of the Central Bank Act, 1997 and the Section 122 of the Credit Union Act, 1997 reports (to include “management letters”). The information must be submitted using the “Online Reporting System” (the same system currently used by credit unions for submitting Quarterly Prudential Returns). Credit unions will not have access to these reports submitted by the auditors.

The system only permits auditors to submit one signed Section 27B (2) (a) report. The system also permits the auditor to submit one draft (if applicable) and one final “management letter”. The file types accepted are Microsoft Word, Microsoft Excel, PDF, JPEG or TIF. If you plan to submit a scanned PDF document, auditors should ensure that they have the facilities to scan the document and create one PDF document.

Appendix 3

Summary of New Regulatory Framework for Credit Unions

3 March 2014

A number of provisions of the Credit Union and Co-operation with Overseas Regulators Act 2012 have been commenced. The main amendments to the 1997 Act arising from the commencement of these provisions are:

- A new section 53 which relates to the board of directors was substituted
- Section 66C which is the requirement for the submission of an annual compliance statement to the Central Bank
- Section 76O(7) which relates to the board oversight committee report to the members at the AGM

The “*Implementation of the New Governance and Prudential Requirements for Credit Unions – Frequently Asked Questions – July 2014*” available on the Central Bank website contains information on the introduction of these new requirements.

1 August 2014

Fitness and Probity regime was fully implemented for credit unions with total assets greater than €10 million and applies to all Pre-approval Controlled Functions and Controlled Functions.

Further details on the Fitness and Probity regime are available on the Fitness and Probity – Credit Unions section of the Central Bank website.