Chapter 1

INTRODUCTION

1.0 Introduction
The Irish credit union movement has witnessed changes in how their surplus is traditionally achieved. With lending growth subsiding in recent times (ILCU, 2007), credit unions have had to resort more dependently to investments to fund their dividend. Depositors are demanding a competitive dividend rate as the marketplace for depositors is competitive. To meet this dividend demand, some credit unions have taken a less conservative approach in their investment strategy, resulting in the acquisition of complex investment instruments (CUDA, 2006). This has led to some credit unions holding investments that may be unsuitable to their needs and outside their understanding, hence increasing the investment risk.

Since the Financial Regulator became the regulating body for credit unions, this investment risk concern has been given more attention through Guidance Notes. Simultaneously, the approach to auditing credit unions has received attention from accounting bodies (Accounting Practices Board, 2007). Accounting issues regarding investments in credit unions are presenting challenges to auditors and investment risk has impacted on the audit process.

1.1 Research question
The review of the literature led to the development of the following question:

How does the changing nature of investment risk in credit unions impact on the audit process?
1.2 Research objectives

After the identification of a problem to form a research question, research objectives were formulated to allow a clearer sense of purpose and direction to assist in the answering of the question. The primary data research was structured and directed around the following research objectives:

- Explore investment risk in credit unions
- Identify the framework in which investment risk in credit unions is managed
- Assess the basis on which these investments are reported in the financial statements and the extent to which the reporting addresses the risk dimensions
- Investigate the issues faced by auditors on the reporting of credit union investments

1.3 Rationale for the study

This study is derived from the documented increase of investment risk in credit unions and the recent media focus of credit unions which have been adversely affected by certain investments. The study also stems from the changing regulatory environment regarding credit union investments as well as responses from accounting bodies on the audit of credit unions. The complexity of credit union investments, credit union Boards’ understanding of what they are investing in, and issues over the valuation of investments and recognition of investment income have received increased attention.

The research aims to provide an insight into investment risk in credit unions and how it impacts on the audit process. The author aims to gain insight into the perceptions and opinions of a number of different interest groups which are connected in some form to this prominent issue.
It can be justified as to why this study should be undertaken at this time for a number of reasons:

- Concern has been expressed in the literature regarding the additional risk credit unions have acquired by undertaking increasingly aggressive investment strategies while not having the expertise to do so.
- The literature has highlighted accounting issues concerning the valuation of investments and recognition of investment income which impacts on the auditor.
- The issues involved are contemporary and have received media coverage. The response from regulators, accounting bodies, and the credit union movement are currently ongoing and by no means complete. There has been limited prior research in this area.

1.4 Research methodology
A qualitative methodology has been employed for this study. In order to answer the research question, qualitative primary research was deemed the most suitable method to provoke perception and depth. As this study impacts on different parties who are connected to the issue of investments in credit unions, perception and depth were seen as key elements to attempt the answering of research objectives of the study. Semi-structured interviewing was seen as the appropriate method to collect data as it would allow exploration of experiences, viewpoints, and perceptions of interviewees. The range of respondents who were interviewed included four credit union managers in the South East, an audit manager working with a larger accounting firm, a high-ranking official working in the office of the Financial Regulator, and a journalist working for a prominent Irish business newspaper.

1.5 Structure of the report
This chapter will introduce briefly the research question, objectives, and methodology. The rationale for the study is also discussed. Chapter two will give an overview of credit unions and discuss the regulatory and governance environment. The chapter serves as a prelude to
chapter three which focus more specifically on the background to credit union investments, recent investment issues, and the audit of credit unions. Chapter four describes the research methodology that was employed and discusses the main primary data collection method. This chapter aims to justify the chosen methodology and limitations to the research are also discussed to help promote a balanced view of the research. Chapter five outlines the findings of the primary data collection. These findings are expanded upon in chapter six where a discussion on those findings is presented. Chapter seven presents the conclusions of the research and discusses some possible future research areas.

1.6 Conclusion
The purpose of this study involves an examination of investment risk in credit unions and its impact on the audit process. It is hoped that the study will provide insight into the changing nature of investment risk in credit unions and allow a conceptualisation of the reasons behind this change. This information may prove relevant to investment committees, Board and management personnel, auditors of credit unions, and indeed members of credit unions. It is also hoped that this investment risk may compliment the understanding of the impact on the audit process by raising awareness.

The author aims to contribute both theoretically and practically to the emerging body of academic knowledge in the area of investment risk in credit unions and the audit of credit unions. The author also hopes to enhance the understanding and awareness of different parties to investment risk in credit unions and its impact on the audit process. Recommended areas for future research will be also discussed in this study.
Chapter 2

LITERATURE REVIEW

IRISH CREDIT UNION OVERVIEW

2.0 Introduction

Irish credit unions have grown significantly since their foundation. This growth is also present in recent years with assets growing from €6.87 billion in 2000 to over €13 billion in 2007 (ILCU, 2007, p.80). Appendix A provides a brief overview of the history and principles of credit unions and how they differ from banks. This chapter will focus on how the movement is regulated and governed. The chapter will also present the development stages of credit unions, as well as possible lessons that could be learned from other co-operatives. This serves as a prelude to address the issues in relation to investments as they are embedded within this economic and regulatory framework.

2.1 Regulation of Irish credit unions

Since May 2003, the Financial Regulator has become responsible for credit unions, taking over from the Registry of Friendly Societies (Department of Enterprise, Trade, and Employment, 2003). In 2003, the Registrar of Credit Unions (RCU) was established by the Irish Financial Services Regulatory Authority (IFSRA). Its scope includes the “regulation and supervision of credit unions and the maintenance of a public record file on each credit union” (IFSRA, 2008). The Financial Regulator’s Annual Report 2007 (p.58) states one of the aims of the RCU is to “enhance the safety and security of members’ savings”. The RCU has the authority to inspect any credit union and Section 87 of the Credit Union Act 1997 grants power to the RCU to give regulatory directions in certain situations. The majority of credit unions are members of the Irish League of Credit Unions (ILCU) which was set up in 1960. The Credit Union Development Association (CUDA), founded in 2003, comprises of former dissatisfied ILCU members.
The credit union movement has traditionally aspired towards self-regulation. The ILCU continues to uphold this aspiration, but CUDA has argued that self-regulation of financial services is no longer viable in a modern economy (CUDA, 2006). For example, a member’s savings in a credit union is not protected in the same way as a customer’s savings in a bank. While the ILCU has a Savings Protection Scheme (SPS), it has stated that it is not a deposit insurance fund, but more of a “stabilisation fund from which discretionary assistance can be given to a credit union in trouble”. CUDA argue that with improved legislation and less self-regulation, savers can get the protection they deserve from the Central Bank’s insurance scheme. In Britain, although the credit union movement is at a less developed stage compared with Ireland, it has more developed legislation and supervision in place. Members’ savings receive the same protection as banks (CUDA, 2006, p.11, 24-29). With the Financial Regulator now regulating credit unions, the concept of self-regulation within the movement is diminishing.

The credibility of the SPS, and indeed the ILCU, has also been questioned in recent years. The ILCU aimed to implement an integrated IT system for credit unions, which was due to start in 2000. The project became known as ISIS and would prove to be a waste of credit union funds and time. Not all credit unions supported the project and project costs dramatically over-ran, deeming it a failure. In 2001, when the ILCU declared they had run out of funds for the project, some larger credit unions broke away from the ILCU to form CUDA. Added to this reputational loss and dissatisfaction within the credit union movement, it was revealed that the ILCU used £5.5million from the SPS reserve fund to finance the failed project. This diminished further the validity of the SPS (Sibbald et al, 2003, pp.423-424).

In June 2007, the Supreme Court overturned the High Court in a case which the ILCU were accused of abusing their dominance regarding the SPS. The Competition Authority alleged that the SPS was in contravention of the Competition Act, as member credit unions were required to avail of this insurance which was provided from a wholly owned and controlled
subsidiary of the ILCU. Some members of the scheme expressed dissatisfaction at the premiums and lack of choice and risked disaffiliation if they did not avail of the service. The Supreme Court found that the SPS was not in contravention of the Competition Act as it was part of the overall service offering of the ILCU (O’Brien and Ryan, 2007). All of these developments show how regulation and deposit protection has altered in recent years against a background of considerable financial growth in a prosperous economy.

2.2 Credit union development stages

McKillop et al (2006) identifies three stages of credit union development; nascent, transition, and mature (see Appendix B). Ireland is in the transition stage. As the credit union movement has grown in Ireland, professional management is now complimenting the voluntary ethos. It is predicted that merger activity, referred to as a transfer of engagements or an amalgamation amongst credit unions, which has been generally non existent up to the present, will accelerate in the coming years. Credit unions cannot acquire shares in another, so the type of merger would be ‘friendly’ instead of hostile (McKillop et al, 2006, pp.45-48).

U.S, Canada, and Australia have seen a wave of mergers in the past. Between 1990-1995, 4,700 credit unions were involved in mergers. In the US, the number of credit unions peaked at 23,900 in 1969 and dropped to 8,500 in 2006 (Fried et al 1999, cited by McKillop et al, 2006, p.332)). In Australia, credit unions have peaked from 700 in the 1970s to 144 by 2006 (Ralston et al, 2001). Canada has also witnessed similar transformation dropping from 7,000 to 1,068 (Appendix C). In Ireland over the next ten years, the inevitability of mergers is generally accepted (Pierce, 2005).

New Zealand is currently at the same development level as Ireland, but more likely to reach the maturity level first. The success of their IT systems implementation in contrast to the ISIS failure is one of the key reasons (Sibbald et al, 2003, p.423). CUDA (2006, p.10) has
recommended “sophistication, automation, consolidation, internationalisation, specialisation, and regulation” as the key areas the Irish credit union movement needs to improve on to help modernise within a ‘new Ireland’ and transform Irish credit unions into the mature stage. The goal is to allow the movement be more compatible within a modern environment instead of relying on a business model that is more suited to a bygone era.

It is suggested that the most viable, sustainable way forward for mergers is through a mixture of amalgamations and networks, helping to reduce costs and increase synergies (Byrne, 2006). As credit union activities become more complex, sophisticated, and integrated, the mutual concept may no longer be desired or sustainable. Larger credit unions who become indistinguishable from retail banks, may consider demutualisation as the next step (Davis, 2005, pp.6-7). Demutualisation in Irish credit unions is not yet an issue as it has not reached the mature development stage. Staatz (1987) argued that co-operatives are more prone to agency problems as performance cannot be measured through market values or by a threat of a hostile takeover. While a hostile takeover is generally not possible in a credit union, an unprecedented event occurred in 2007 in the US. Wings Financial Federal Credit Union attempted to takeover Continental Federal Credit Union by offering each of Continental’s 25,000 members a payment of $200 if they voted in favour of the takeover. Continental rejected the offer (Kristof, 2007).

While mergers and demutualisation are possibilities in the later development stage of a credit union, a deep attachment within the movement to the mutuality concept exists and this should not be underestimated in any change process.

2.3 Lessons learned from other co-operatives

The demise of the agricultural co-operative movement provides a valuable lesson for the credit union movement. Quinn (1999, p.13-14) described some factors for the eventual decline of the movement to include inadequate disclosures and over-reliance on support
from the government. The Knapp Report (1964) criticised Irish co-operations for not being co-operative enough amongst each other. Briscoe and Ward (2005, p.70-71) discussed other factors which impacted on the demise, such as not distributing dividends and farmers being able to use services without becoming members. With the agricultural co-operative movement failing to live up to original expectations, several co-operatives abandoned these principles and set up public limited companies such as Kerry Foods PLC in 1986.

Co-operative banking like any financial institution relies on trust and perception. Negative perceptions can be damaging. The Savings and Loans crisis in the US shows the troubles a co-operative bank can incur. Curry and Shibut (2000) estimated that the crisis during the 1980s and 1990s cost the US taxpayer in the region of $124 billion (p.33). The Savings and Loans Association is a form of a mutual bank. The US taxpayers’ funds were used to solve the crisis that incurred unprecedented losses on loans and investments which were caused by interest rate exposures, deregulation, governance problems, and unfavourable lending risk (p.27).

2.4 Governance of credit unions

For many companies, the world of governance has two timelines; pre-Enron and post-Enron. The resulting legislation following the large corporate scandals at the turn of the century has effected not-for-profit organisations as well as corporate organisations (Credit Union Magazine, 2007). Best practices published by the WOCCU, requires the Board to have a fiduciary responsibility to their membership and have a level of prerequisite skills. The supervisory committee needs knowledge of internal control to implement them to an appropriate level. Likewise, with the credit committee, knowledge of lending and risk is required. Exhibit 2.1 highlights some of the potential risks a credit union can be exposed to.
Today good governance requires more from a Board in a society and economy that is increasingly turbulent and complex since the start of the credit union movement. Further problems may arise if the elected Board does not have necessary financial, operational, or compliance skills, or indeed the time as many Board members also have full-time occupations (Branch and Baker, 2000). “EU and Irish law require that the directors and managers of financial services firms regulated by the Financial Regulator meet standards of competence and probity” (Financial Regulator, 2006a, p.1). The Fit and Proper Requirements instruction paper issued by the Financial Regulator (2006a) specifically excludes directors of credit unions from the fit and proper test. It is understood that this exclusion is an issue that will be examined in the future.

As membership grows in credit unions, it is argued that the Board cannot claim to be representative of the majority of members, minorities of the membership elect the board (Davis and Donaldson, 1998), and the democratic ethos is lost (Davis, 2001). While credit unions operate as a democracy it could be argued that it is a ‘weak’ democracy as membership turnout at AGMs is low and Boards tend to be self-perpetuating. Therefore it is

Exhibit 2.1 – Potential risks that a credit union may be exposed to

Source: CUDA (2006)
questionable whether Boards of credit unions are representative of the membership, competent, and balanced.

2.5 Conclusion

This chapter provided an overview of the credit union movement. It discussed the changing environment of regulation for credit unions. Credit union development was discussed and Ireland’s credit union development level was examined. Issues from the SPS and the ISIS project were highlighted. Lessons to be learned from other co-operatives were also discussed. The governance of credit unions was explained and the limits to this governance were identified. The next chapter will focus more specifically on investments in credit unions.
Chapter 3

LITERATURE REVIEW

INVESTMENTS IN CREDIT UNIONS

3.0 Introduction

Credit unions have witnessed change in regulation and in their financial position in recent years. The previous chapter dealt with an overview of the movement. This chapter aims to present the issue of investments in credit unions. Investments are being used by the movement to aid surpluses as their loan to total assets ratio has been diminishing in recent years. Investments carry a level of risk that may not have been experienced by a Board in the past. New challenges are now presented to the auditor in terms of auditing a credit union’s financial statements, specifically the investments. This chapter highlights the main issues that currently arise in the investment domain in a credit union and the how they are addressed by an auditor.

3.1 Current credit union issues

The ILCU 2007 Annual Report revealed that savings in the credit union movement totalled €13.4 billion (p.87). The Loans/Asset ratio which measures the percentage of assets that is loaned out to members totalled 47.84% (p.80). Approximately €47 of every €100 taken in is subsequently lent out. It is desirable to make this percentage as high as possible so the dividend demand from savers can be met more easily. In 1997 this ratio was 67% and has been declining since. The ILCU feel the ideal ratio would be 75% (Weston, 2008a). Since 2000, the growth in loans has been decreasing with the exception of 2005 (p.87). This decline has occurred in a period when household debt has increased significantly. The Central Statistics Office (CSO) (2007, p.161) revealed that lending by credit institutions to the private household sector has increased from €39 billion in 2000 to €134 billion in 2006. This growth increase has not been present in credit unions. Exhibit 3.1 shows a comparison
between credit union loan growth and household debt growth between 2000 and 2006. It should be noted that the household debt growth includes mortgage figures which have seen unprecedented growth levels due to the relaxation of lending standards and rising house prices. Credit unions do not provide mortgages on a movement wide scale. It may also highlight how credit unions have missed out on this growth potential by failing to provide mortgages.

Exhibit 3.1 – Comparison between credit union loan growth and household debt growth between 2000 and 2006


The credit union movement has come under pressure in recent times from a more competitive marketplace, leading to credit unions no longer providing the cheapest source of finance. With more choice, the consumer can borrow from alternative sources. While Ireland has witnessed the ‘Celtic Tiger’ era with consumers becoming wealthier, the level of borrowing in credit unions has declined as mentioned previously. This has lead to a number of credit unions lending with less due diligence, subsequently decreasing the loan quality and increasing bad debts.
A credit union can be described as a pure co-operative. Members interact on both sides of the financial intermediation market by both supplying and borrowing funds, unlike other co-operatives where members only interact on one side of the market (Taylor, 1971). With both sides of the market interacting in the one credit union, it can raise the issue of member conflict. Saver-dominated credit unions want the best possible dividend while borrower-dominated credit unions want the lowest possible interest rates resulting in a rate squeeze where each group would attempt to expropriate wealth from one another. The deteriorating loan market share has not decreased savers’ demand for a competitive dividend rate. The saver has the choice in a competitive marketplace to search for a high return. The dividend demand is affected by what other credit unions and other financial institutions are offering their savers. This can lead to credit unions filling this dividend demand through investing. However, as a higher return is required, there is a danger that some investment activity may be outside the expertise of the credit union. This may put members’ savings into unacceptable risk levels, and may not be in compliance with the Credit Union Act 1997, or relevant guidance from the Financial Regulator (CUDA, 2006, pp.6-7).

CUDA highlighted how the “credit union share of the consumer loan market has been steadily dropping during a time when consumer borrowing has been booming” (p.6). It deems Section 35 of the Credit Union Act, 1997 which imposes limitations on long-term lending as a cause. Another cause is the failure of credit unions to change their business model which has been largely unchanged since it was first developed. This business model no longer reflects the Ireland of today (p.8-9). As a result, lenders are going elsewhere, with credit unions experiencing a decline in their loan quality (p.6). The report cites the ILCU Rationalisation Committee Report of 2006 where increasing delinquency on loans was presented as a worrying challenge and this continues to be so in 2008.

With the decreasing quality of the loans in a credit union combined with economic uncertainty, the lending risk of the credit union is inevitably increased. Media coverage of the increasing bad debts in Monaghan Credit Union highlighted the potential risk of lending.
With €7.5 million in bad debts (Weston, 2006), dividends were prohibited due to the intervention by the Financial Regulator. With the ILCU’s SPS aiding Monaghan Credit Union (Monaghan Credit Union Annual Report 2007, pp.16-17), it was able to take the loss, but did experience a deposit run (The Credit Union Journal, 2006).

With lending no longer the main provider of surpluses for credit unions, investments have been seen as the area in which to fill this ‘surplus demand gap’. Exhibit 3.2 compares the traditional method and current method of financing the dividend.

Exhibit 3.2 - Financing the dividend – traditional method and current method

Exhibit 3.3 presents a sample of investments to total assets ratios taken from the annual accounts of five credit unions in the South-East for 2006 and 2007.
3.2 Credit unions and investments

The RCU Guidance Note on investments by credit unions (2005) requires the Board to appoint an investment committee and approve a written investment policy. The fundamental principle for an investment policy is that “investments by credit unions must not involve undue risk to members’ savings”. The investment committee must comprise of at least three people, one who is a director, and meet at least once a month.

The Financial Regulator’s Guidance Note on investments by credit unions (2006b) requires the Board of to ensure “that its’ investments comply with the Board’s investment policy” and the Guidance Note. Credit unions are limited to different classes of instruments that they can invest in (Appendix D). In a speech delivered by the RCU, Brendan Logue, in 2007, he addressed a number of issues concerning investments. As the biggest single asset class held by credit unions, the security, liquidity, and the risk profile of the investments are essential considerations for an investment committee in their decision making process. This is consistent with the principle that investments must have a capital guarantee and be liquid.
(Financial Regulator, 2006b). Due diligence on the risk of the investment as well as the fitness and probity of the investment advisor are essential considerations for the investment committee. The committee or the Board cannot be remunerated, and they must be independent to the providers of the investments.

The limits outlined in Appendix D can be over-ridden if the credit union can demonstrate to the RCU “that they possess the skills and systems necessary to manage a more complex investment portfolio”. Exhibit 3.4 shows the contrast of different investment strategies that can be employed by credit unions.

Exhibit 3.4 Different credit union strategies for investments

Changes in credit union guidance policies on investments have also been witnessed in credit unions in the mature development stage. In the US, the National Credit Union Administration changed a number of elements in relation to investments in recent times. A
broker must have a minimum criteria level before a credit union can transact with that broker and due diligence on investment advisors must be carried out. Investment limits have been expanded to allow credit unions to manage risks such as currency risk (CUNA, 2002).

3.3 Recent investment issues

In September 2007, the Financial Services Ombudsman (FSO) issued a report in favour of Enfield Credit Union after a complaint was brought against Davy Stockbrokers. The decision is currently being appealed by Davy. The complaint centred around three perpetual bonds which were purchased by Enfield Credit Union. The case demonstrates how a credit union can hold investments which can go against the investment philosophy of having a capital guarantee at an identifiable future date. They appeared to receive insufficient explanation on the nature and terms of the investment and they may not have sought it either. Enfield Credit Union incurred a loss of €77,041 on its €500,000 investment (p.5)

The Enfield Credit Union is not the only credit union involved with perpetual bonds that have decreased in value. Media coverage throughout 2008 has focused on this. Some 149 credit unions have bought these controversial perpetual bonds and have incurred losses similar to Enfield’s situation. With the outcome currently pending, it is uncertain whether further complaints will be received by the FSO or if further litigation will be taken, despite Davy offering to underwrite future losses and reimburse a proportion of the losses already incurred. It is currently unknown whether Davy’s offer will be accepted by holders of these bonds (Percival, 2008; Barrington, 2008a; Weston, 2008b).

Enfield Credit Union questioned a potential conflict of interest involving the ILCU. The ILCU receive a commission from Davy for each credit union introduced. Davy is also the advisor to the ILCU’s Central Investment Management Agreement which has been in operation since 1997, allowing credit unions invest in a centralised fund. Davy has been the advisor of this fund since the beginning (FSO, 2008, p.39). Enfield is critical at the lack of
support the ILCU has given during its’ complaint against Davy. Enfield has called into question “the appropriateness of the league acting as an investment adviser to credit unions; the process involved in appointing the league’s investment advisers; the legal relationship between the league and its investment advisers and the implications of the league promoting a particular investment adviser to member credit unions” (Barrington, 2008b). Members’ trust in the ILCU may be damaged and the ILCU’s reputation may also be damaged.

Credit unions have also been exposed to bonds issued by the International Securities Trading Corporation (ISTC). ISTC was a lending firm which became insolvent in 2007. The E-Services and Communications Credit Union wrote down €10 million due to their exposure to these bonds (Barrington, 2007). From the credit union perspective, the situation does not look favourable in the public domain. Members want stability in their credit union, as in any financial institution, and losing money on investments and not comprehending financial instruments does not suggest stability. With the Northern Rock crisis of September 2007 still in the publics’ mind (BBC, 2007), the credit union cannot pay out all savings in the event of a run. The perpetual bond controversy could have a lasting damage on the movement’s credibility and reputation.

The sub-prime crisis highlights that investors should critically evaluate information on valuations from providers of securities. If they cannot fully understand the security, they should not purchase it, even if it is marketed attractively. The impact of certain collateralised debt obligation (CDO) investments has reinforced the message that “if the instrument is too complex to be understood by an investor, it should not be purchased” (Doran-Walters, 2008). Members do not want to see those who have a fiduciary duty investing without proper due diligence and consideration. If one credit union loses its members’ trust, it may impact negatively on the whole movement. Members in other credit unions may not differentiate their credit union from other credit unions and this could lead to
negative generalisations. The Savings and Loans crisis in the US, as mentioned in the previous chapter, demonstrates this point.

The Forfas Expert Group on Future Skill Needs focused, as part of the report, on the role of investment managers for the international financial services sector. Some of these important roles needed included portfolio management, risk management, and compliance (pp.65-66). The concluding recommendations for the future included education to obtain appropriate skill sets, training to allow the expansion of foundation level skills, and research to help develop leading edge thinking and solutions (p.200). This report can help an investment committee determine what skills and roles are required both in the present and perhaps in the future. The report can also help a credit union determine what skills and roles are required from any advisors or intermediaries they use in the dealing and purchasing of investment products.

3.4 The audit of credit unions

Credit union audits can present as many risks and challenges as a profit driven organisation. The importance of safeguarding assets is crucial, so the importance of internal control and risk management must be strongly enforced by credit union management, Boards and supervisory committees. Since its establishment, the movement has amassed large resources, but it is also faced with more challenges and complexity. The auditor needs to take into consideration that auditing a credit union can be more problematic today, especially with the additional compliance requirements.

Section 122 of the Credit Union Act, 1997 places a statutory duty on the auditor to file a report to the Financial Regulator on matters that were encountered during the audit. This places extra responsibility on the auditor as there is an extra intended user of the financial statements who may place a certain reliance on the auditor’s opinion. The July 2004 Guidance Note for the Auditors of Credit Unions states that “IFRSA relies on the external
Auditor’s reports on the financial statements of credit unions”. Independence for the auditor is crucial. “The independence of the auditor from the firm that he is auditing is one of the basic requirements to keep public confidence in the reliability of the audit report” (Hayes et al, 2005, p.83). The Guidance Note helps address this by recommending that the audit partner should be rotated every five years no later than the accounting period ended 30th September 2007.

With investments now the largest single asset held by credit unions, if not audited appropriately, the risk of material misstatement in the report on the financial statements would be high. Auditors must place a degree of reliance on the investment committee, the supervisory committee, and the Board in terms of internal controls. The level of reliance will be determined by the existing inherent risks and control risks. Investments have had more pronounced risk attributes in recent years as revealed in the earlier discussion.

The Auditing Practices Board has issued a Practice Note dealing with the audit of credit unions in the Republic of Ireland. The Financial Regulator has indicated that fair value accounting may not be permissible under the Credit Union Act, 1997 (paragraph 24). Paragraph 29 states how the auditor may have a reporting responsibility to the Financial Regulator on issues of significance that are encountered during the audit. Paragraph 145 details how investment risk is a significant risk in credit unions. Paragraph 157 describes how the valuation of investments is an area that requires special audit consideration. Paragraph 162 comments how these special audit considerations “include the nature and valuation of investments and other financial instruments for which valuation techniques are required”. Paragraph 162 details how it is common in credit unions to outsource investment management.

The auditor must consider the carrying amount of the investment up to the date of the auditor’s report, and decide if a write-down is required (paragraph 170). External
confirmations are a typical requirement for the auditor and investment held with investment managers and custodians may require external confirmation (paragraph 172). Paragraph 176 details how confirmation directly to the auditor can be used as direct audit evidence. Investments not traded on an active market can represent a significant risk as accounting estimates may be required for valuation purposes (paragraph 180). Paragraph 198 demonstrates that a management representation letter should be obtained to determine the adequacy and appropriateness of any accounting estimates. Paragraph 185 focuses on how the auditor should be aware of intentional or unintentional management bias. The investment position of a credit union may place the entity at a liquidity risk and ultimately a going concern doubt. Paragraph 195 discusses the reporting responsibility of the auditor to the Financial Regulator, if the funding or liquidity position is unstable.

A common problem with credit unions today is that they are generally not exploiting their full lending potential as highlighted earlier. They may become over-invested, and acquire exotic, complicated products as part of their investment portfolio. Howard (2007) identified the difficulty in valuing perpetual bonds, highlighting that credit unions cannot “mix and match” between the cost and fair value model. It was also discussed that some credit unions had not expensed write-downs in the value of their perpetual bonds and income from investments should be recognised on an accruals basis. Some credit unions that hold perpetual bonds may have a limited secondary market for these assets. It was found that they had been relying on statements from sellers of these products for valuations, when they should have been independently valued.

The Institute of Chartered Accountants in Ireland’s (ICAI) May 2007 Information Sheet entitled “Information for Credit Union Auditor” guides auditors on situations where they may advise credit union management and the Board. These situations include advising on the processes used to identify the nature of investments and the process used to identify and assess the valuations of investments held. Auditors can also advise on the allowable accounting options for investment and the consequences of using these different options.
Auditing has been regarded as both a structured, mechanistic process and a judgemental process. Professional judgement will always be required in some form (Smith et al, 2001). The auditor needs to be aware that verifiable information does not guarantee accurate information. Large elements of financial statements are comprised by some degree of management estimates. It is not until a later date that these estimates can be verified accurately. The sub-prime crisis for showed how investment vehicles such as CDOs, which received AAA ratings from credit rating agencies, were in hindsight found to be of higher risk than AAA would historically have suggested. Credit rating agencies suffer a conflict of interest as they are hired and paid by the companies and products that they rate (Doran-Walters, 2008). The European Commission is also in discussion with the Committee of European Security Regulators in relation to the supervision of, and the over-reliance by investors on these credit rating agencies (EUROPA, 2008).

Investment disclosures may change in the near future due to recent economic conditions. IFRS 7, Financial Instruments: Disclosure is currently recommending “that companies improve their disclosures regarding all financial instruments, not just CDOs, and provide adequate disclosures of exposures to risk, risk management, accounting policies, and valuation methodologies”. A working group, comprising of members from the six largest accounting firms, feel that the current market conditions will force companies to make additional disclosures (Doran-Walters, 2008). This may also impact on credit union disclosures. The RCU has indicated that a proposed Guidance Note on accounting for investments is due before September 2008 (RCU, 2008).

3.5 Conclusion

This chapter discussed the changing environment of credit unions and the issues surrounding investments in credit unions. The investment environment in credit unions has seen change and controversy in recent years. Relevant internal, external and international factors have been addressed in this chapter in relation to investments. It is clear there are a number of outstanding issues that are matters of concern for credit unions, regulators and auditors. All
three groups have responded in some form to address these issues. The issues of investments have revealed an interaction between different parties. Exhibit 3.5 contextualises this interaction. This conclusion of the literature review will now lead on to the research methodology in the next chapter.

Exhibit 3.5 – Interaction of parties involved in the investment issue of credit unions
Chapter 4

RESEARCH METHODOLOGY

4.0 Introduction

This chapter will present the methodology chosen for the research. The research problem is identified, and the research objectives are outlined. Details and justifications of the research methodology are presented, and the sources of secondary and primary data are explained. The method of primary data research is described and the chosen sample method in formulating the collection of this data is also outlined. Operational details in the collection of this primary data are discussed and limitations to the study are focused on.

4.1 Research problem overview

A research problem is a clearly stated and specific study within boundaries that is of some significance and is justifiable (Hussey and Hussey, 1997, p.132-133). Sekaran (2000, p.67) sees it “useful to define a problem as any situation where a gap exists between the actual and the desired ideal states”. The research problem for this study centres on the examination of investment risk in credit unions and how it impacts upon the audit process.

The use of investments in the credit union movement has been a problematic area in recent years. The previous chapters examined how credit unions have been relying more on investments to help meet dividend levels, increasing the exposure to investment risk. The literature examined responses from regulators and accounting bodies. The literature also discussed some issues that have occurred recently, regarding investments in credit unions such as perpetual bonds. There are still outstanding issues regarding investments in credit unions that are not dealt with in regulation and policy. This study will examine investment risk in credit unions and how it impacts on the audit process.
4.2 Research question

To help address the research problem, a clear, focused research question needs to be developed. Consistent with Saunders et al (1997, p.22), the research question has been derived from the initial literature review in the previous chapters. A ‘gap’ in the existing literature has been identified. The research question can therefore be expressed as:

How does the changing nature of investment risk in credit unions impact on the audit process?

4.3 Research objectives

Maylor and Blackmom (2005) discuss that objectives should be specific, measurable, achievable, realistic, and time-framed. Saunders et al (1997, p.23) suggests that research objectives lend clearer purpose and direction to the research question. The research question has led to the emergence of a number of objectives. These objectives will develop the structure of the primary research.

4.3.1 Objective number one

Explore investment risk in credit unions

The decreasing loan to total asset ratio has been a common trend in the credit union movement in recent years. Credit unions are using investment income to aid the dividend rate (ILCU, 2007; CUDA, 2006). Investments carry various risks for credit unions. The effect of investment risk has been witnessed in recent times in the credit union movement and it is an issue that has been addressed by regulators. The first objective of this study will be to explore investment risk in credit unions.
4.3.2 Objective number two

Identify the framework in which investment risk in credit unions is managed

The Credit Union Act, 1997 is the main Act which governs the credit union movement. The Financial Regulator has issued guidance on how investment activity should be carried out. These Acts and guidance are aimed to help manage investment risk in credit unions. Elements of a framework may include training, limits on certain investments, internal controls etc. The purpose of this objective is to identify the framework in which investment risk in credit unions is managed.

4.3.3 Objective number three

Assess the basis on which these investments are reported in the financial statements and the extent to which the reporting addresses the risk dimensions

The reporting of investments has been a controversial area in recent times (Howard, 2007). Instruments such as perpetual bonds have presented a challenge as to how they should be valued. There have been indications that fair value reporting in the financial statements may not be permissible under the Credit Union Act, 1997 (Accounting Practices Board, 2007). When to recognise accrued income has also been a problematic issue. IFRS 7 has indicated more onerous disclosure notes in the future for investments. The aim of this objective is to assess the basis on which the investments are reported in the financial statements and the extent on which the reporting addresses the risk dimensions.

4.3.4 Objective number four

Investigate the issues faced by auditors on the reporting of credit union investments

For the auditor, a credit union can present a different challenge in comparison to other financial institutions. There have been issues in the past concerning how income and capital from investments are to be valued as well as the independence of the investment advisor (Howard, 2007). The perpetual bond controversy may present further challenges to auditors
in terms of valuation and disclosure. The final objective is to investigate the issues faced by auditors on the reporting of credit union investments.

4.4 Overview of the research design process

The research design is the development of a method detailing how the research question will be answered (Hussey and Hussey, 1997, p.132-133). Ghauri and Gronhaug (2002, p.47) suggest that to answer the research problem efficiently, the design should be developed strategically. Exhibit 4.1 outlines an overview of the research design.

Exhibit 4.1 – Overview of the research design
4.5 Research methodology

It is necessary to use a methodology to achieve the research objectives. Qualitative and quantitative are the two main methodologies that can be utilised, so a contrast between both is necessary.

4.5.1 Qualitative research versus quantitative research

The qualitative approach allows the researcher to be close to the respondent and allows flexibility (Sarantakos, 1998, p.55). Saunders et al (1997, p.339) highlights how quantitative research leads to explanations being more standardised and number-based, and diagrams and statistics are used for analysis. In contrast, qualitative research allows explanations to be expressed through words, results are collected in a less standardised form, and conceptualisation is the method used for analysis.

Patton (1980, p.13-14) describes how qualitative methods allow issues to be studied in depth and detail. The quantitative approach can allow generalisations, while the qualitative approach produces a wealth of detailed information that can reduce generalisations. Mason (2002, p.180) characterises inductive reasoning as the scrutinizing of data to develop a theory. This is in contrast to deductive reasoning where a theory is developed first and the process involves moving from “the general to the particular”. The former approach allows Glaser and Strauss’s (1967) grounded theory approach to be developed where the theory is created from the data. Bryman and Bell (2003) explain that qualitative research usually involves inductive reasoning while quantitative research involves deductive reasoning.

Qualitative research can allow rich description of attitudes and perceptions which can help gain insight and interpret certain phenomena (Hakim, 2000). Hussey and Hussey (1997) classify depth as being a dominant feature of qualitative research as opposed to breadth being the dominant feature with quantitative research. While the study has the inherent
elements of a deductive approach as a literature review had been formulated before the collection of data, the research methodology mainly takes an inductive position. Instead of aiming to test theory, the study focuses on perception and response as key components to develop explanations and theories. Given that the research topic has implications to different parties, perspective and depth were deemed crucial elements for this study. Qualitative analysis was therefore seen as the most suitable approach to provoke perception and response, as well as allowing inductive reasoning.

### 4.6 Data collection methods

A critical element of the research process is data collection. Using multiple sources of data collection can lend rigor to research (Sekaran, 2000, p.258). Data sources can be both primary and secondary. Primary and secondary data sources were utilised in this study and were essential to the research process.

#### 4.6.1 Secondary data

Secondary data can be described as data that already exists and has been gathered by others for different purposes. This data which was originally collected for one purpose can be re-examined for another purpose (Lewis, 2003, p.76). To begin the answering of the research questions, secondary data can be very useful (Saunders et al, 1997, p.158). Secondary data is crucial for a comprehensive review of the literature and helps ensure no critical variables are overlooked (Sekaran, 2000, p.61). Numerous different sources were used to access secondary data for this study. The electronic search engines in Waterford Institute of Technologies’ Luke Wadding Library such as ABI Inform, Business Source Premier, Emerald Fulltext, and Science Direct were accessed. Publications from regulators, accounting bodies, and credit union associations were important sources. The World Wide Web was also made use of. The author notes, as Saunders et al (1997, p.169) points out, that secondary data may have been collected originally for a different purpose and this was acknowledged in the use of it. A number of different sources of literature were used in
developing points to help mitigate this concern. Table 4.1 shows the categories and range of secondary data that was used.

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<td>1</td>
<td>1</td>
<td>17</td>
</tr>
<tr>
<td>Press</td>
<td>8</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>9</td>
</tr>
<tr>
<td>Speeches/Addresses</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Other</td>
<td>4</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>39</strong></td>
<td><strong>27</strong></td>
<td><strong>8</strong></td>
<td><strong>5</strong></td>
<td><strong>79</strong></td>
</tr>
</tbody>
</table>

*Table 4.1 – Categories and ranges of secondary data used*

**4.6.2 Primary data**

Sekaran (2000, p.57) suggests that primary data is the gathering of information through observation and enquiry. Data is collected by the researcher through interaction with parties involved within the problem area and can be collected through a number of methods. The following is a summary of the utilised method and other methods that were deemed inappropriate are also discussed.
4.6.2.1 Interviews

Patton (1990, p.278) suggests that “the purpose of interviewing.... is to allow us to enter into the other person’s perspective”. Sekaran (1992) describes interviews as “a data collection method in which the researcher asks for information verbally from respondents”. For the study, the main method of primary data collection was through semi-structured personal interviews. Bryman and Bell (2003) explain that semi-structured interviews do not limit the interviewer to a standardised list of questions. Saunders et al (1997, p.215) highlight how this form of interviewing can allow flexibility and additional interaction. For these reasons, semi-structured interviewing was seen as the most suitable approach as several parties were being interviewed.

Sarantakes (1998, p.267) highlights some of the risks associated with interviews. These include being time consuming, not allowing as much anonymity compared with other methods, the potential of bias from the interviewer, and less effectiveness with sensitive issues as the interviewee may be more conscious when verbally responding. In order to address these risks the author limited the interviews to less than one hour, made no direct mention to the identity of the interviewee in the research to ensure confidentiality, kept personal opinion out of the interview questions as much as possible, and asked the interviewee to verify their response once the interview was complete.

4.6.2.2 Other methods

Other primary data collection methods were considered for this research:

- Surveys- Jankowicz (2000) highlights how surveys allow breadth as questions can be addressed to large amounts of respondents. Surveys were deemed inappropriate as the aim of this study is exploratory in nature and depth was considered an important element. It was also felt that the perception gained from semi-structured interviews would not be as prevalent in surveys.
• Longitudinal Study – Hakim (2000) explains how this method studies the social change process over a long period of time. This method was not viable due to time, resource, and access constraints.

• Action Research - Remenyi et al (1998, p.49) describes this method as a contribution to knowledge and taking action. The researcher attempts to prescribe change and problem-solving within an organisational setting. The author deemed this method inappropriate due to the lack of sufficient access to an organisation and the demand on time.

4.7 Sampling

Since the aim of this research is not to generalise, purposive sampling was employed. Patton (1990) discusses that purposive sampling involves selecting subjects because of certain characteristics and for a particular purpose. Hussey and Hussey (1997, p.144) comment that sampling should allow results to be extrapolated to the whole population. Purposive sampling does not allow or aim for this extrapolation. The interviewees were chosen because they were information ‘rich’, knowledgeable, and had different roles to play and perspectives to express in relation to the research question. The sample was chosen after reviewing literature, and discussions with college lecturers. Exhibit 4.2 presents the different parties who were interviewed. Contact was made with the interviewees through email and telephone conversations, help from college lecturers, and through personal contacts.
4.7.1 Rationale for the chosen sample

As the research is exploratory in nature, the insights of different parties were key elements to the study. The different interviewees were chosen because they had information to contribute to the research question. Four South-East credit union managers were interviewed. All of the credit unions are large in terms of assets and membership. These managers have professional financial backgrounds and are part of the investment committee of their respective credit union. An auditor working for a large accounting firm, who manages the auditing of many credit union clients in the South-East, was interviewed. A journalist for a leading Irish business newspaper was chosen, and this journalist has written numerous articles on credit unions. A high ranking official in the Financial Regulators Office, whose office has issued guidelines on the research question, was also interviewed.
4.8 Fieldwork details

Seven interviews were conducted. All interviews were recorded and transcribed to compliment note-taking and to allow the interviewer to concentrate on the interview. The transcript word count came to over 28,000 words. Yin (1994, p.86) discusses that recording can provide accurate rendition of the interview. Permission was obtained before all recording. To validate the information obtained, transcripts were emailed to the interviewees for verification. Interviewees verified the transcripts with some minor changes. Confidentiality was important due to the potential sensitivity of the study, so all interviewees’ identities were given a pseudonym.

The interview design was semi-structured. The interview questions were designed to fit around the research objectives. Respondents from different backgrounds and roles were interviewed so the interview design varied from interviewee to interviewee to accommodate their specialist knowledge. Some interviewees had the ability to address certain research objectives in more detail than others (refer to Appendix E, F, G, and H for draft interview questions). The questions were open-ended questions to allow the interviewee to expand and explain responses as much as possible. Interviewees were given the opportunity to discuss any further issues they saw as relevant. Throughout the interview process certain responses provoked further ad-hoc enquiries from the interviewer to acquire as much information as possible. Table 4.2 presents the operation details of the interviews carried out.
Table 4.2 – Operational details of interviews carried out

<table>
<thead>
<tr>
<th>Interviewee</th>
<th>Date</th>
<th>Location</th>
<th>Duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Union A</td>
<td>9th July 2008</td>
<td>Waterford</td>
<td>37 minutes</td>
</tr>
<tr>
<td>Credit Union B</td>
<td>10th July 2008</td>
<td>Waterford</td>
<td>35 minutes</td>
</tr>
<tr>
<td>Credit Union C</td>
<td>7th August 2008</td>
<td>Waterford</td>
<td>30 minutes</td>
</tr>
<tr>
<td>Credit Union D</td>
<td>7th August 2008</td>
<td>Waterford</td>
<td>40 minutes</td>
</tr>
<tr>
<td>Auditor</td>
<td>23rd July 2008</td>
<td>Kilkenny</td>
<td>35 minutes</td>
</tr>
<tr>
<td>Financial Regulator Official</td>
<td>29th July 2008</td>
<td>Dublin</td>
<td>40 minutes</td>
</tr>
<tr>
<td>Business Journalist</td>
<td>29th July 2008</td>
<td>Dublin</td>
<td>40 minutes</td>
</tr>
</tbody>
</table>

4.9 Limitations of the study

The author acknowledges there are limitations in this research. As the main primary data collection method was through interviewing, the parties used were credit union officials, regulators, auditors, and other people who are someway connected to the research title. These geographically dispersed individuals must be aware of confidentiality and commercial sensitivity, as well as having limited time to conduct interviews. Other parties who would have been valuable contributors to the study were not available for an interview due to many reasons. The qualitative methodology approach was chosen at the expense of a quantitative approach with depth and perception seen as the crucial advantage. The sample chosen was also limited due to time and resource constraints. Therefore generalisations cannot be made from the sample chosen.
4.10 Conclusion

This chapter focused on the research methodology employed for this study. The chapter identified the research ‘gap’ and subsequent objectives. The strategy adopted for primary data collection was discussed as were the secondary data sources used. Other methods of primary data collection that were considered were briefly outlined. The operational details of the primary data collection were explained and the limitations of the research were identified to conclude the chapter. The next chapter will present the findings that were revealed in the primary data collection.
Chapter 5

FINDINGS

5.0 Overview

This chapter will present the primary research findings that were uncovered by means of the semi-structured interviews. The findings are split into the following themes:

- Risk environment for investments in credit unions
- Causes and sources of investment risk
- Investment committee structure, skills, and policy
- Investment guidelines
- Internal controls
- Valuation of investments
- Investment disclosures in the financial statements
- Issues on auditing investments
- Future audit issues

Interview questions and responses from the interviewees will be presented around each of the above mentioned themes. Appendix I provides additional quotations and information on the primary data findings, and is referred to when required, highlighting the range of perceptions and opinions that were described in the interviews. Table 5.1 details the reference system employed to present interview quotations and comments from respondents in an economic fashion.
Table 5.1 – Details of reference system used for interview quotations and comments

<table>
<thead>
<tr>
<th>Interviewee</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit union manager – Kilkenny</td>
<td>CU1</td>
</tr>
<tr>
<td>Credit union manager (1) – Waterford</td>
<td>CU2</td>
</tr>
<tr>
<td>Credit union manager (2) – Waterford</td>
<td>CU3</td>
</tr>
<tr>
<td>Credit union manager (3) – Waterford</td>
<td>CU4</td>
</tr>
<tr>
<td>Audit manager – South East</td>
<td>AD</td>
</tr>
<tr>
<td>National business journalist</td>
<td>BJ</td>
</tr>
<tr>
<td>Official in Financial Regulator’s office</td>
<td>FR</td>
</tr>
</tbody>
</table>

5.1 Risk environment for investments in credit unions

The respondents were asked to describe how investment risk is present in credit unions. FR gave a historical overview and commented that the Trustee Authorised Investment Order, 1998 “broadened out the range of instruments that credit unions could invest in” while simultaneously “savers began to become pre-dominant over borrowers”. FR discussed the concentration of risk that credit unions consequently experienced and described how the two unequal income streams from investments and lending led to longer-term, more exotic investing (see Appendix I, 5.1.1)

BJ also commented on this imbalance between savers and lenders and quoted “my impression is that this imbalance is relatively unique to the credit union sector”. BJ saw services such as ATMs, longer-term lending, and mortgages which credit unions do not provide on a large scale as a cause also and stated “how that relates to investment risk, well, you don’t have new consumers coming through the door".
CU1 stated the range of risks present in credit unions:

*It’s similar to any other sector or financial institution; you have the risk to capital, and the risk of liquidity, the penalty of breaking terms, and also the inflation risks and opportunity risks [CU1].*

CU2 identified additional risks as expertise risk and not being able to analyse advice (see Appendix I, 5.1.2). CU3 saw investment risk as not being “sure of the return you will receive in the future….even though investments are 100% capital guaranteed….returns in all cases are not”. CU4 explained that “credit unions have got to find the optimum investment which will pay over a long period of time securely but also meet the short-term demand from members, so there is a risk there in trying to merge both”. CU4 also felt that credit unions hold the “risk of becoming a savings club”.

When questioned about the challenges in identifying investment risk, CU4 discussed that “identifying the bank institution risk is a challenge because people think local….there is a loyalty factor built in for going to Irish products”. CU2 commented that the investment committee needs to “critically analyse the advice they’re being given” to deal with investment risk. CU1 commented that “reading the product and trying to differentiate between the products” were important factors to deal with investment risk and that this was also a difficulty. CU3 discussed how having “confidence in the advice forthcoming from investment advisors” is a challenge. CU4 explained that “there is no software to help you with your investments….I find it hard to put the investments down in black and white overall”.

40
5.2 Causes and sources of investment risk
When asked to explain possible reasons for how investment risk has changed the general opinion was that the growth in complexity of products, the lower interest rates in recent years, and the global markets have all been influential (see Appendix I, 5.2.1)

CU1 commented how “credit unions are seen as a lucrative market” and consequently are “bombarded with the product offering”. The issue of not receiving independent advice was seen as a major source to investment risk (see Appendix I, 5.2.2).

CU1 noted that regulation contributed to the investment risk:

....regulation has increased the risk, as you are more limited in what you can invest in, so the positive returns can be limited in an economic downturn.

However, regulation was seen as a factor which has decreased investment risk by others as it helped focus the credit union’s investment strategy. Having more information about risk factors was also seen as a decreasing factor (see Appendix I, 5.2.3).

5.3 Investment committee structure, skills, and policy
Respondents were asked about the structure of the investment committee. AD responded that having a dominant manager could be a danger in a voluntary environment. FR questioned the investment committee structure, feeling they were too trusting of their advisors. FR also suggested “head-hunting’ people with expertise” and to “employ fee based advisors rather than product producers”. BJ suggested that the credit union movement may benefit from having a head office for investments where experts are hired for the movement and was critical of the broker relationship (see Appendix I, 5.3.1).
Credit unions were asked about the composition of the investment committee and responses were mixed as some saw the composition to be appropriate while others saw it as weak (see Appendix I, 5.3.2). When asked about their investment policy, most credit unions noted that it was up-to-date to handle investment risk, while one explained that it was in draft stage (see Appendix I, 5.3.3).

CU1 and CU2 highlighted that the investment committee are selected based on expertise. CU1 emphasised the skills and qualifications of their current committee to include various financial qualifications and industry experience, stressing that “it’s a fairly strong investment team”. CU2 responded that their committee has similar qualities as described by CU1.

As regards training for the investment committee members, the general opinion that it was too simplistic and not value adding. However, CU3 commented that they received training from an external expert and felt it adds value (see Appendix I, 5.3.4). CU3 noted that internal training and guidance from relevant bodies is not adequate and stated how it is “typically in reaction to an event or events and it is usually too late, so it is not proactive at all”. CU4 explained that investment committee members do go to seminars but also noted “there is no formal education, it is self-education”. CU4 also warned that there is a danger that the committee could “change every year so you have different people coming on each year”. Asked if credit union directors should be subject to Fitness and Probity requirements, it was the general opinion of all the respondents that they should be (see Appendix I, 5.3.5).

The factors that the investment committee is conscious of when making investment decisions were explained by the credit unions to include security, liquidity, and yield (see Appendix J, 5.3.6).
5.4 Investment guidelines

When asked if the Financial Regulator’s Guidance Notes are suitable and complete for credit union investing, CU2 stated “I think the Guidance Notes at the moment are good, sound, prudent practices for an investment portfolio”. BJ commented that the Guidance Notes are “trying to set out the parameters of an investment policy….credit union leaders aren’t in a position to advise its’ members down these very risky routes”.

CU3 felt that the investment guidelines “are restrictive for sophisticated investment committees and large credit unions….they take no account of past performance of investments by particular credit unions or sophistication of their investments and they tend to be based on an overreaction on issues arising in the movement”. CU3 also felt that product producers are aware of these restrictions and that “they appear to tailor and price their products accordingly” and suggested that credit unions themselves would be able to put these products together and avoid unnecessary commissions.

CU4 was also critical about the investment guidelines stating "I don’t know where the parameters came from”. CU4 believed that the Financial Regulator enforced different accounting policies on their credit union than they did on another credit union in relation to income recognition.

CU1 felt that “credit unions should be looked at individually within groupings” and CU2 made a similar point. However FR reacted on these points by explaining that it would be difficult to create, monitor, and assess groupings as doing so would not be compatible with the one-size fits all principle of the credit union movement (see Appendix I, 5.4.1).

When asked if it would consider applying for the exemption to invest outside the investment guidelines, respondents generally felt it was too onerous and ambiguous a process (see
Appendix I, 5.4.2). FR revealed that “we’re not approving any of them (exemption applications) at the moment because of the nature of the capital markets”.

CU2 made a point on credit unions’ attitude to Guidance Notes:

....the attitude in credit unions towards regulation is poor....from talking to people in the banking sector....Guidance Notes carry much more weight that just guidance....

BJ suggested that credit unions are resistant to change and regulation and used Brendan Logue’s speech at the National Supervisor Forum in November 2007 about credit unions not taking the guidelines seriously to back up this point (see Appendix J, 5.4.3).

5.5 Internal controls
The respondents were asked to discuss the internal controls present for investments. CU1 emphasised the segregating of duties between accounting for investments and the signing off on bank accounts as important controls. CU4 described how their internal control committee has developed an internal control questionnaire for investments.

As regards the decision making process, credit unions responded:

The investment committee presents a monthly report to the Board....the Board make the decision, except short-term decisions....The treasurer or myself would make that decision so we can avail of the opportunity [CU1].

The Board has given the autonomy to the investment committee to conduct its’ affairs without having to refer back to the Board [CU3].
They (the investment committee) must seek Board permission, but not first….they are ratified later on, by way of an investment committee report to the Board [CU4].

In addition, CU4 discussed how the decision making process is now more democratic than it was in the past. BJ raised questions about the controls over the perpetual bonds that were bought by Enfield Credit Union:

....those bonds were missold but whether they were also misbought is another question. Did the people fully understand the risks?

CU2 commented how “parameters” are set to address the major risk areas. AD commented that “the internal controls are quite robust....as long as they have the division of duties between recording and checking, I think they’re (credit unions) fine”. CU3 described the reporting controls present such as the “monthly valuations and movement reports to the Board” and noted “there is also an independent quarterly valuation prepared by the investment advisors and circulated to the Board”. CU4 highlighted similar reporting and valuation controls.

5.6 Valuation of investments

The credit unions were asked to outline their accounting treatments for investments. The responses indicated that investment valuation and income recognition was prudent and consistent with FR’s response (see Appendix I, 5.6.1).
When asked about the valuation of perpetual bonds, AD discussed that if these bonds do not have an active market, there can be difficulties in valuing them. CU1 suggested valuing such bonds at a multiple of the coupon rate, but AD was opposed to this (see Appendix I, 5.6.2).

Some respondents were asked to discuss the historic cost and fair value accounting models and it was felt that the fair value accounting model was not suitable for valuing investments in credit unions (see Appendix I, 5.6.3).

When questioned about the recognition of income, FR stressed a “return to common sense” and only to recognise income “which is realised”. FR also revealed that credit unions which previously recognised unrealised gains distributed these gains as a dividend and saw this situation as highly undesirable. CU1 didn’t share the FR view on recognising income only when received feeling that income that is realisable in a ‘balloon payment’ outside twelve months should also be recognised in certain circumstances (see Appendix I, 5.6.4).

CU4 explained that their credit union was forced to write back a large amount of the surplus into a reserve by the Financial Regulator shortly before the AGM due to the accruing of income outside the one year threshold. AD noted that income should only be accounted for if guaranteed before explaining that extra information will be put into an appropriation account in the future for income that will not be received within a year and which cannot be distributed.

5.7 Investment disclosures in the financial statements

When asked on credit union investment disclosures, AD noted although credit unions are complying with requirements, it does not disclose much information to the user but this may change in the future (see Appendix I, 5.7.1). AD felt that the disclosure note doesn’t adequately inform the user of accounts of the risk involved with investments.
CU3 felt more transparency on investment products should be present in future disclosures. CU4 discussed that profit and losses on revaluations need more disclosure. CU4 also questioned the appropriateness of a snapshot of investment figures at a balance sheet date stating “you can have bad luck on a balance sheet today and great luck tomorrow....if it was mentioned somewhere else what the yearly average was....or some sort of a built up average”.

FR stated three desirable principles for disclosures; “one is transparency....secondly consistency, and thirdly compliance with law”. FR then stated a future change in disclosures that would address transparency in relation to income:

\[\text{We want to divide it down between....what’s realised, what’s receivable in a year, and what’s receivable outside of that.}\]

On the matter of consistency, FR revealed:

\[\text{....we don’t want credit unions changing their accounting policies to suit particular circumstances....we’d like to see...that the same accounting policies applies to loan and investment income, i.e. you only record it when you get it.}\]

The credit unions were asked to outline the disclosure note on investments in the annual accounts and how it has changed. CU1 highlighted that it has not changed as the lower of cost and net realisable value was always used. CU3 revealed how the basis of investment valuation and how investment income is accounted for is now disclosed and this was not done so in the past.
Asked if the perpetual bond issue will impact on future disclosure requirements, the credit unions indicated that changes are likely (see Appendix I, 5.7.2). CU4 explained that it will experience a write-off for 2008 due to a decrease in value of perpetual bonds and this could lead to the introduction of their first investment committee report in the financial statements.

CU3 described how the AGM could be used as the appropriate forum to inform the member on investments as part of the investment committee report as the disclosure notes to the financial statements may not necessarily expand enough to accommodate this. CU3 also felt that “it may be desirable.....to have the investment advisor representative present (at the AGM), so you have all the relevant parties”.

BJ made a point on credit unions disclosing investment losses such as the recent perpetual bond issue:

....institutions don’t want to draw attention to the fact that they’ve maybe bought a product that isn’t performing very well. It could dent confidence.

5.8 Issues on auditing investments
The credit unions and FR were asked to describe the main issues auditors have discussed when auditing investments. FR stated “there would be a range of concerns with the quality of the books of accounts, the administration, and the various provisions of the Act (Credit Union Act, 1997)”.

CU1 explained “the main thing is in terms of recognition of income and losses and gains” when asked on issues that auditors have discussed when auditing investments. CU2 commented:
....we’ve always tried to be very prudent with our valuations and that has led to no major issues.

CU3 commented that the main issue has been to “avoid recognition of unrealised gains. Essentially take a conservative but realistic approach and obviously consistency from year to year is important as well”. CU4 commented:

The auditors are inclined to look at nominal ledger entries and accounting for income valuations at the year end. I don’t remember any auditor asking for third party verification….I don’t ever remember hearing of a third party circulation for investments ever.

5.9 Future audit issues

When asked about the issues auditors will face when investments will be audited in the future, it was felt a higher quality would be necessary from auditors and valuations will continue to prove difficulty (see Appendix I, 5.9.1). CU4 stated that they will be accepting Davy’s recent offer to compensate for the decrease in the value of certain perpetual bonds which will lead to accounting issues and subsequent issues for the auditor. CU4 also stated that when the Financial Regulator insisted on the income write back for that particular credit union, the auditor was used to audit all investments and report back to the Financial Regulator. CU4 finally commented that the auditor should in the future “look at what is the likelihood that the investment will remain to maturity....what is the institutional risk and who made the investment decision.”
5.10 Conclusion

This chapter discussed the primary research data that was collected from the respondents. As highlighted in the previous chapter, the main source of primary data was derived from semi-structured interviews. The findings were identified under themes that will help in the answering of each research objectives. The different perspectives and quotations of the respondents were presented. Appendix I accommodated extended quotations and findings from the respondents as it was not possible to include all this data in the chapter. The next chapter will present a discussion of the findings and certain contrasts and comparisons with the literature review will be made accordingly.
Chapter 6

DISCUSSION

6.0 Introduction

This chapter will discuss the findings from the primary data research. The research objectives will be expanded into themes of discussion. These themes will form the structure as to how the findings of the primary research data findings are to be analysed. The discussion is presented under the same theme headings in which the findings were presented.

6.1 Risk environment for investments in credit unions

The literature suggests the risk environment for investments has increased in recent times. Credit unions have seen change to this environment as lending growth has diminished, investment growth increased (CUDA, 2006; ILCU, 2007). With investments now the single biggest asset class for many credit unions, the dangers of investment risk is leveraged as instruments become more complex and diverse.

The findings concur with the literature and indicate that the risk environment for a credit union is now extensive. The findings identify a saver to lender imbalance and highlight how credit unions can experience a concentration of investment risk owing to mitigation from brokers, lenders, and members. The findings also reveal a range of risks that respondents need to be conscious of such as counterparty risk, interest rate risk, liquidity risk, and expertise risk. These risks are consistent with the concerns which the RCU’s Guidance Note (2006) has addressed.

The findings suggest that investment committees find it difficult to identify risks as they tend to be myopic and unable to analyse information. This may have implications for
regulators and credit unions as a minimum competency requirement level is desirable for investment committee members.

6.2 Causes and sources of investment risk

The literature indicates that the increasing complexity of credit union investment products has been one of the main sources of investment risk. The findings indicate this and other factors were also identified. The low interest rate environment in previous years was a factor as credit unions could not acquire a satisfactory return from short-term deposits and were forced instead to seek longer-term instruments. The complexity of investments has made credit unions more exposed to global financial markets.

The Accounting Practices Board (2007) stresses the importance of an independent investment advisor. This importance is highlighted in the findings as a factor that may decrease investment risk. A product producer also acting as an advisor appears to be an undesirable situation shared by credit unions, regulators, and auditors alike. Drawing on this, it is suggested that an independent investment advisor advising credit unions is highly desirable.

6.3 Investment committee structure, skills, and policy

The RCU (2006) requires credit unions to have an investment committee and an updated investment policy. The structure and competencies of the investment committees are questioned in the literature. They do not have the same fitness and probity requirements as other financial institution directors. The findings reveal that all the credit unions have active investment policies, with the exception of one credit union. These investment policies are structured to handle risk. The findings show that the structure of the committee appears strong in some cases while weaker in other cases. Factors identified which impact on the decision making process include risk and return trade-off, diversification, security, liquidity,
and yield which reflect the RCU Guidance Note (2006) objectives. Again, the findings identify the importance of the independent investment advisor to assist the investment committee.

The findings highlight that training from associate bodies is inadequate. It is recommended to structure the investment committee with people of financial experience and qualifications and to head-hunt these individuals if necessary. This reiterates the point that credit union directors should have a minimum competency requirement. If not possible, it is suggested that credit unions procure external training from outside experts as training from credit union associate bodies is not sufficient and tends to be passive. This may have implications and opportunities for associate bodies of credit unions to be more proactive and improve their training for investments.

6.4 Investment guidelines
The RCU Guidance Note (2006) sets limits in which a credit union can structure its’ investment policy (see Appendix D). A credit union can apply to be exempt from these limits if they demonstrate through an application process that they have the skills and systems to justify an exemption. The recent perpetual bond issue has identified negative consequences of credit unions holding products outside these guidelines.

The findings suggest that the Guidance Note has strong aspects to aid prudent investment strategies. However, credit unions, the users of the Guidance Note, feel that the one size fits all structure is not appropriate. They feel different degrees of limitations should be enforced on credit unions based on past performance, the expertise and qualifications of the investment committee, and other similar set criteria. This suggests that investment Guidance Notes are not complete and should be developed further over time to perhaps deviate from the one size fits all approach. One credit union also questioned the rationale behind the set
limits. This may have implications for the Financial Regulator to further justify and explain these limits to credit unions.

It was found that Guidance Note exemption applications are all being rejected owing to the current economic climate. Credit unions feel that the application process is too onerous and ambiguous and the fact that applications are being automatically rejected concurs with this opinion. A possible solution may involve eliminating the application process. The ‘all or nothing’ nature of the exemption renders it undesirable to grant by the Financial Regulator and perceived as unachievable to obtain by credit unions. It could be replaced by an application process where credit unions could apply to invest in certain investment categories (e.g. insurance products as CU1 suggested) which are outside the Guidance Note limitations. If credit unions could justify their competencies and reasoning in doing so, then the Financial Regulator may be willing to grant smaller exemptions. Credit unions may be able to invest in what they were historically efficient at, while still being within the scope of the Guidance Note.

6.5 Internal Controls
The RCU Guidance Note (2006) on investments deals with internal controls by addressing the need for an investment committee and a Board approved written investment policy. This helps focus decision making controls and sets out a degree of autonomy for the investment committee. This committee is required to report to the Board adding accountability and ensures reporting controls are in place. The auditor needs to test and assess the internal controls as part of the audit process, so adequate controls are imperative for the formulation of a true and fair assertion.

The findings indicate that credit unions are aware of the need for internal controls. While the research does not explore these internal controls in great detail, they appear to be present for investments. Credit unions commented on a number of controls. Segregation of duties and
the presence of an internal control questionnaire for investments were identified in the findings. The decision making process for credit union investment committees show that they have freedom to conduct but have reporting responsibilities to the Board. The Enfield Credit Union case shows the downside to this autonomy as the findings questioned if the perpetual bonds were misbought and if the proper controls were present. Having an independent investment advisor can help strengthen reporting controls as they provide reports independently to the Board on the investment committees’ activities. Exhibit 6.1 suggests a tool that investment committees could use for investment decisions. It could also be used as a control mechanism where decisions can be compared, rationalised, and justified.
### Investment Decision Comparator

<table>
<thead>
<tr>
<th>Options:</th>
<th>Location of instrument:</th>
<th>Nature of Instrument:</th>
<th>Duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Institution 1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Institution 2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Institution 3</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Assessment of Financial Institution Options

<table>
<thead>
<tr>
<th>Institution 1:</th>
<th>Institution 2:</th>
<th>Institution 3:</th>
</tr>
</thead>
</table>

- **Credit Rating:**
  - Instrument
  - Institution

- **Capital Guaranteed? (Yes/ No)**

- **Compliance with Guidance Notes?**

- **Penalties of breaking terms**

- **Yield**
  - Best Case
  - Worse Case

- **Maturity Date**

- **Effect on Liquidity Ratio**

- **% of investment portfolio invested in this institution if option chosen**

- **Other information**

---

*Exhibit 6.1 – Suggested decision support tool pro-format for the investment committee*
6.6 Valuation of Investments

The Credit Union Act, 1997 requires a prudent approach to the valuation of investments and the recognition of income. The literature highlights how some credit unions started adopting fair value accounting and recognising unrealised gains. These practices were addressed by Logue (2007) when he stressed prudence and rejected fair value accounting as a viable option for credit unions to use.

The findings agree with the literature. Interviewed credit unions take a prudent approach that is in line with the Credit Union Act, 1997. One credit union described how they were forced to make a write-down by the Financial Regulator, which reveals that the prudent approach is being enforced. The findings identify a level of disagreement with the Financial Regulator’s approach as some credit unions questioned the appropriateness of only being allowed to recognise realised income.

The findings further reveal issues concerning the valuation of perpetual bonds. Owing to investments in poorly performing bonds, some credit unions have experienced liquidity problems with these bonds as a valuation is difficult to calculate. The advantage of having an independent investment advisor to give valuations and not just rely on the investment manager’s valuations was made evident. Valuing these bonds at a multiple of the coupon rate was seen as a last alternative by AD. An explanation for this opinion may be due to the subjective task of calculating a suitable discount rate.

6.7 Investment disclosures in the financial statements

Disclosures are designed to inform the user of accounts with additional information. The credit union movement has witnessed a shift in the risk exposure due to investments. The literature highlights how this risk is also applicable to the saver in a credit union as the savers funds are not protected in the same fashion compared with other financial institutions.
The IFRS 7 working group discuss that the CDO crisis that has developed may lead to additional disclosures on investments in general and not just CDOs.

The findings indicate that while credit unions are complying with disclosure requirements on investments, respondents stressed that they were inadequate in informing the member of the risk involved. FR indicated that the disclosure note is likely to see change in the future with transparency, consistency, and compliance being the three core principles. The credit unions acknowledged that their disclosure note on investments needs expansion. Exhibit 6.2 suggests an expanded pro-format disclosure note that a credit union could use and Appendix J compares the current disclosure note for investments for 2007 in a sample of credit unions.

An interesting point was raised by one credit union. The AGM could be used as the forum to disclose the risks to the member and that the independent investment advisor representative should attend the meeting. This would help inform members of the risk and provide information on investments.

The perpetual bond controversy was seen by most respondents to be the driving factor that may expand the disclosure note. This may be due to increased public awareness owing to recent media coverage of investment losses in credit unions, consistent with the idea that increased public awareness of the CDO issue has been one of the key driving factors in the recommendations made by the IFRS 7 working group.
## INVESTMENT DISCLOSURE NOTE

Investments are stated at the lower of cost and market value

<table>
<thead>
<tr>
<th>Investment Category</th>
<th>Valuation Method</th>
<th>Amount Invested</th>
<th>Change from Prior Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>€</td>
<td>€</td>
</tr>
<tr>
<td></td>
<td></td>
<td>%</td>
<td>%</td>
</tr>
</tbody>
</table>

Investment income is recognised when realised

<table>
<thead>
<tr>
<th>Investment Category</th>
<th>Income Recognition Method</th>
<th>Income Recognised</th>
<th>Receivable in 1 Year</th>
<th>Receivable Outside 1 Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>€</td>
<td>€</td>
<td>€</td>
</tr>
</tbody>
</table>

Investment write-down details (if applicable):

<table>
<thead>
<tr>
<th>Investment Category</th>
<th>Reason for Write-down:</th>
<th>Write-down</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>€</td>
</tr>
<tr>
<td></td>
<td></td>
<td>%</td>
</tr>
</tbody>
</table>

Change in investment accounting policy (if applicable):

<table>
<thead>
<tr>
<th>Details:</th>
<th>Reasons:</th>
<th>Financial Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>€</td>
</tr>
</tbody>
</table>

Exhibit 6.2 – Suggested disclosure note pro-format
6.8 Issues on auditing investments

The literature highlights how auditing investments in credit unions has exposed new challenges. Accounting bodies have attempted to address this by issuing standards (Accounting Practices Board, 2007). Due to the complex nature of investments, the auditor is required to undertake additional testing and verification to decide if investments present a true and fair view. The valuation of certain investments and the recognition of income are two areas that require such additional work (Howard, 2007). Using credit rating agencies and investment managers to verify risk and valuations has been called into question recently because of liquidity issues of these investments and the lack of independence from both parties (EUROPA, 2008; Doran-Walters 2008).

The findings concur that valuations of investments and recognition of income have been prominent issues for auditors. The credit unions revealed that these two areas have been the main points of focus that auditors have discussed with them in relation to investments. The main concern of the auditor has been to implement a prudent, consistent, and realistic approach to investments. It was found that an auditor of one credit union did not use third party verifications for investments. While perhaps unnecessary in that given situation, it may be appropriate to use independent third party valuation verifications for investments in light of the issues highlighted in the literature and the findings.

6.9 Future audit issues

It is likely future audit issues will arise in relation to investments in credit unions. The literature discusses that Davy has made a compensation offer to holders of the controversial perpetual bonds. If accepted by the credit unions, the accounting adjustments will be complicated and may lead to further accounting issues (Barrington, 2008b). The Financial Regulator is becoming more active in the enforcement and monitoring of prudent accounting policies (Logue, 2007). This along with the auditor’s reporting responsibility to the Financial Regulator on matters of concern may place extra pressure and responsibility on the
auditor and the audit report. The expected Guidance Note from the RCU later in 2008 may help address some of these elements (RCU, 2008).

The findings reveal consistencies with the literature review. Respondents agreed that investments in credit unions are likely to lead to future audit issues. FR discussed that a higher quality of auditing is desired from some auditors which demonstrates that the Financial Regulator is expecting more from the auditor of a credit union. Findings also indicated that expected large write-downs of perpetual bonds in many credit unions for 2008 may lead to valuation problems for auditors. Instruments with illiquid markets will continue to present challenges. The Davy offer to credit unions was also identified as an area that will be challenging to address by both credit unions and auditors.

These findings may have implications for the accounting bodies to agree a standard of best practice that addresses these future issues. The findings may also impact on some auditors to ‘up-skill’ and develop an understanding of credit unions and investments to raise the audit quality level. Again, the findings demonstrate the value of an independent investment advisor to provide independent valuations. This may aid in the level of write-downs on perpetual bonds and also aid auditors of credit unions who will have accepted the Davy proposal.

**6.10 Conclusion**

After discussing the research findings, it is revealed that the findings concur overall with the literature. However, some findings presented various issues and expanded on existing issues that were not addressed in the literature. Throughout the chapter, areas that were not addressed in the literature were identified, and certain courses of action were suggested by the author. The next chapter will present a conclusion to the study. The analysed findings and recommendations will be summarised and how the research objectives were addressed will be revealed.
Chapter 7

CONCLUSION

7.0 Introduction

This chapter summarises the main findings of the study and outlines how each research objective has been addressed to answer the research question. Areas of the study that may have implications for different interest groups will be identified. The chapter concludes by recommending possible areas of further research and presents some concluding comments.

7.1 Summary of findings and recommendations

7.1.1 Research objective one

Explore investment risk in credit unions

<table>
<thead>
<tr>
<th>Key Findings</th>
<th>Recommendations</th>
<th>Presence in existing literature</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk increased owing to saver and lender imbalance</td>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td>Concentration of risk on credit unions</td>
<td></td>
<td>New</td>
</tr>
<tr>
<td>Range of current risks identified</td>
<td>Committee members to have a minimum competency requirement</td>
<td>Expanded upon</td>
</tr>
<tr>
<td>Difficulty in committee identifying risk</td>
<td>Appoint an independent investment advisor</td>
<td>Expanded upon</td>
</tr>
</tbody>
</table>

Table 7.1 – Table addressing the details of research objective one

Exhibit 7.1 conceptualises increasing and decreasing factors which have impacted on the investment risk level over time.
### Exhibit 7.1 – Factors impacting on investment risk in credit unions

<table>
<thead>
<tr>
<th>Decreasing Factors</th>
<th>Increasing Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Credit Union Act, 1997 &amp; Trustees Investments Order, 1998</td>
<td>- Saver and lender imbalance-investments help maintain dividend level</td>
</tr>
<tr>
<td>- Financial Regulator becomes regulating authority, 2003</td>
<td>- Low interest rate environment-leads to long-term investing</td>
</tr>
<tr>
<td>- Development of Registrar of Credit Unions Office</td>
<td>- Emergence of diverse products and an increase in the number of product producers</td>
</tr>
<tr>
<td>- Emergence of fee-based independent investment advisors</td>
<td>- Over reliance on, and too trusting of broker for education and information</td>
</tr>
<tr>
<td>- Lessons learned from investment issues involving credit unions in 2007/2008</td>
<td>- Credit unions investing in instruments outside their understanding and suitability</td>
</tr>
</tbody>
</table>

**Investment Risk Level Timeline**

- Concentration of risk on credit unions
- Range of current investment risks & risk identification challenges
7.1.2 Research objective two

Identify the framework in which investment risk in credit unions is managed

<table>
<thead>
<tr>
<th>Key Findings</th>
<th>Recommendations</th>
<th>Presence in existing literature</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment policies up-to-date and suitable to handle risk</td>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td>Committee’s decision making considerations identified</td>
<td>Appoint an independent investment advisor to aid decision making</td>
<td>New</td>
</tr>
<tr>
<td>Training provided by associate bodies inadequate</td>
<td>Appoint people who have the expertise, or procure external training. Possible opportunity for associate bodies to actively provide training.</td>
<td>New</td>
</tr>
<tr>
<td>Guidance Note is suitable but not complete</td>
<td>Limits need more justification and deviate from the one size fits all approach</td>
<td>New</td>
</tr>
<tr>
<td>Exemption application not achievable</td>
<td>Discontinue the application and set up an application to apply for smaller, more specific exemptions</td>
<td>New</td>
</tr>
<tr>
<td>Adequate internal controls present</td>
<td>Enforce controls to justify decisions to avoid inappropriate product purchasing and an independent investment advisor can strengthen controls</td>
<td>New</td>
</tr>
</tbody>
</table>

*Table 7.2 – Table addressing the details of research objective two*
7.1.3 Research objective three

Assess the basis on which these investments are reported in the financial statements and the extent to which the reporting addresses the risk dimensions

<table>
<thead>
<tr>
<th>Key Findings</th>
<th>Recommendations</th>
<th>Presence in existing literature</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment valuations and income accounted for prudently</td>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td>Fair value accounting seen as unsuitable</td>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td>The Financial Regulator appears to be enforcing prudent accounting</td>
<td></td>
<td>Expanded upon</td>
</tr>
<tr>
<td>Some credit unions disagreeing with Financial Regulator’s prudent approach</td>
<td>Scope for Financial Regulator and accounting bodies to justify the approach and be consistent in the implementation</td>
<td>New</td>
</tr>
<tr>
<td>Difficulty in valuing perpetual bonds with no active market</td>
<td>Appoint an independent investment advisor for independent valuations</td>
<td>Expanded upon</td>
</tr>
<tr>
<td>Disclosure note on investments inadequate</td>
<td>Expand the disclosure note, use the AGM as the forum to provide additional information</td>
<td>New</td>
</tr>
<tr>
<td>Perpetual bond controversy seen as a driving factor in expanding the disclosure note</td>
<td></td>
<td>Expanded upon</td>
</tr>
<tr>
<td>Have independent investment advisor present at AGM</td>
<td></td>
<td>New</td>
</tr>
</tbody>
</table>

*Table 7.3 – Table addressing the details of research objective three*
7.1.4 Research objective four
Investigate the issues faced by auditors on the reporting of credit union investments

<table>
<thead>
<tr>
<th>Key Findings</th>
<th>Recommendations</th>
<th>Presence in existing literature</th>
</tr>
</thead>
<tbody>
<tr>
<td>Main issues are the valuation of investments and recognition of income</td>
<td>Use independent sources to aid in the valuation</td>
<td>Expanded upon</td>
</tr>
<tr>
<td>Third party verifications not conducted in a particular audit</td>
<td>Conduct third party verifications to assure valuations are independent and up-to-date</td>
<td>New</td>
</tr>
<tr>
<td>Write-downs for perpetual bonds for 2008 likely</td>
<td>Use independent investment advisors to aid in this process</td>
<td>New</td>
</tr>
<tr>
<td>Davy offer may present accounting issues if accepted</td>
<td></td>
<td>Expanded upon</td>
</tr>
<tr>
<td>Concern from regulator over quality of credit union audits</td>
<td>Accounting bodies to publish standard of best practice to address this</td>
<td>Expanded upon</td>
</tr>
<tr>
<td>Expected Guidance Note in September 2008 may address these issues</td>
<td></td>
<td>Yes</td>
</tr>
</tbody>
</table>

Table 7.4 – Table addressing the details of research objective four

Drawing on the overall research objective findings, Exhibit 7.2 presents a diagrammed overview to how an auditor may audit investments
Exhibit 7.2 – Overview of how an auditor may audit investments

- **Plan**
  - Understand credit union structure.
  - Gain insight into the nature of investment risk.
  - Awareness of potential factors that may lead to material misstatement.
  - Materiality of investments.

- **Test Controls**
  - Documents from investment brokers.
  - Valuations from independent investment advisors.
  - Third party circularisation.
  - Examine investment policy.
  - Management representations letter.
  - Discussions with management and committee members.

- **Evidence**
  - Reliability of valuations.
  - Reliability of independent advisors.
  - Level of prudence attached to the valuation of investments and recognition of income.
  - Compliance with Guidance Notes and legislation.
  - Valuation of instruments with no active market.

- **Interpret**
  - Audit Report.
  - Report to the Financial Regulator.
  - Management letter.

- **Report**
  - Knowledge of future Guidance Notes and legislation in relation to investments.
  - Awareness of external factors that may impact in the future on investments.
  - Up-skill audit staff to meet future demands.
  - Knowledge of best practices and standards issued from accounting bodies.

- **Learn**
  - Knowledge of future guidance in relation to investments.
  - Awareness of external factors that may impact in the future on investments.
  - Up-skill audit staff to meet future demands.
  - Knowledge of best practices and standards issued from accounting bodies.
7.2 Implications for credit unions

The research highlights the importance of a well-structured, skilled investment committee and an investment policy that can handle risk. Training for investments in credit unions needs addressing and it is likely committee members will require minimum competency levels in the future. Training or having people with relevant qualifications can mitigate adverse investment risk to an acceptance level. The study also identifies the considerations a credit union needs to address in decision making and accounting for investments. An extended disclosure note and the use of an independent investment advisor are suggested.

7.3 Implications for auditors

The study reveals how investment risk affects the accounting aspect of investments and how this has impacted on the audit process. Investments have become more complex, regulation has increased, and certain products are becoming increasingly difficult to value. The study suggests that the auditor uses independent investment advisors to verify valuations. The findings also reveal that the quality level of auditing needs improvement.

7.4 Implications for regulators

The findings indicate that credit unions feel the Guidance Notes are not complete, and that the one-size-fits-all approach is not sustainable. This has implications on the Financial Regulator to further justify, expand, and develop the Guidance Notes. There are also implications on accounting bodies to develop a best practice standard to help deal with the complicated accounting issues and help raise the audit quality of their constituent audit firms.
7.5 Further research

This study has identified the following areas that may be considered for further research:

- This study focused on perception and depth. Research similar to this study is needed to accommodate for breadth, as a wider range of perspectives may broaden the understanding of how investment risk has impacted on the audit process.

- Quantitative research on investments in a wide population of credit unions may highlight in quantitative terms how investment risk has changed and how regulation has impacted on this risk.

- This study focused on investment risk. A study focusing on lending risk in credit unions and its impact on the audit process is viable owing to the change in credit unions’ lending environment.

- Longitudinal research exploring investment risk in credit unions can be carried out to examine the effects it has on the audit process in more depth.

- A qualitative study similar to this study in a number of years time, could re-examine the changing nature of how investment risk in credit unions has impacted on the audit process.

7.6 Concluding comments

The study set out to explore the changing nature of investment risk in credit unions and how it impacts on the audit process. The conclusion of the research is that investment risk impacts significantly on the audit process. As investments in credit unions have increased in complexity and size, auditors are faced with accounting issues that were not as prevalent in the past. The size of investments has grown significantly making the materiality of these assets even higher. The auditor is likely to face complex challenges even more so in the future, suggesting that proper best practices need to be developed. It is evident that investments have presented new challenges to investment committees to possess levels of prerequisite skills. There are also implications on the Financial Regulator to further develop
upon the Guidance Notes to address outstanding issues and address investment risk further which will serve beneficial to the auditor and credit unions in the future.
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Financial Services Ombudsman (2008), Enfield Credit Union –v- Davy Stockbrokers: Final Decision of the Financial Services Ombudsman


APPENDIX A

Overview of Credit Unions

In the 1850s, Friedrich Wilhelm Raiffeisen set up the first credit union in Flammersfeld, Germany. This credit union would create and adapt the fundamental principles which are still equally as relevant today. The first North American credit union would not be established until the early 1900s when set up in Quebec, Canada (WOCCU, 2008). Since these early beginnings, the credit union movement in 2006 has grown into an international movement with over 46,000 credit unions serving 172 million members and a global asset base which has surpassed the US$1 trillion mark (WOCCU, 2006). The World Council of Credit Unions (WOCCU) is the leading international trade association and development agency for worldwide credit unions.

The credit union movement in Ireland was first established in 1958 when Nora Herilhy co-founded the first credit union in Dublin. Ireland has over five hundred and twenty five credit unions, with savings of over €13.4 billion (www.creditunion.ie).

Credit unions are owned and controlled by members and operate as not-for-profit organisations. Resources are pooled together and members can save and borrow. The credit union operating principles consist of open and voluntary membership, democratic control, limited dividends on equity capital, returns on savings and deposits, return of surplus funds to members in the form of a dividend, non-discrimination, services to members, on-going education, co-operation among co-operatives, and social responsibility (ILCU, 2008). Membership is conditional on a common bond concept and follows a ‘one member one vote’ principal where every vote is equal regardless of deposit size (Goddard et al, 2001, p.2328). A common bond limits membership within a specific community, area, or profession.
Credit unions differ from commercial banks. They do not operate for profit, they help the financially weaker areas of society obtain affordable finance, and they have a strong voluntarism ethos including an unpaid Board of Directors (Frame et al., 2003). Banks operate as profit maximising commercial entities. The common bond, while it helps improve loyalty, also presents a constraint for credit unions to attract members unlike banks. Raising capital is also a constraint, as credit unions can only use retained earnings, unless the credit union initiates demutualisation. Banks however, can raise capital on equity markets (Emmons and Schmid, 1999).

The customer base for a credit union also differs to banks. Credit unions members consist mainly of the household sector. Banks have customers both from the household sector and also from the commercial business sector (Schmid, 2005, pp.50-51). The banking industry in New Zealand perceives credit unions as an increasing threat, as they are on the brink on the mature development stage. This follows the same trend that occurred and continues to occur in the US, Canada, and Australia (Sibbald et al., 2003, p.420-421).

In Ireland, the taxation of credit unions has sparked a debate involving banking institutions and credit unions. Credit unions are exempt from paying corporation tax on their earnings (Taxes Consolidation Act, 1997, Section 219 (a)). The tax concession may allow higher dividends or lower loan rates, but there is also the danger in management not channelling these savings to the members but instead to itself which is consistent with the concept of agency theory (Hinson and Juras, 2002).
### APPENDIX B

#### Stages of Credit Union Development

<table>
<thead>
<tr>
<th>Attributes of a Nascent Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small asset size</td>
</tr>
<tr>
<td>Highly regulated</td>
</tr>
<tr>
<td>Tight common bond</td>
</tr>
<tr>
<td>Strong emphasis on voluntarism</td>
</tr>
<tr>
<td>Serves weak sections of society</td>
</tr>
<tr>
<td>Single savings and loans product</td>
</tr>
<tr>
<td>Requires sponsorship from wider credit union movement to take root</td>
</tr>
<tr>
<td>High commitment to traditional self-help ideals</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Attributes of a Transition Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large asset size</td>
</tr>
<tr>
<td>Shifts in regulatory framework</td>
</tr>
<tr>
<td>Adjustments to common bond</td>
</tr>
<tr>
<td>Shifts towards greater product diversification</td>
</tr>
<tr>
<td>Emphasis on growth and efficiency</td>
</tr>
<tr>
<td>Weakening of reliance on voluntarism</td>
</tr>
<tr>
<td>Recognition of need for greater effectiveness and professionalism of trade bodies</td>
</tr>
<tr>
<td>Development of central services</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Attributes of a Mature Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large asset size</td>
</tr>
<tr>
<td>Deregulation</td>
</tr>
<tr>
<td>Loose common bond</td>
</tr>
<tr>
<td>Competitive environment</td>
</tr>
<tr>
<td>Electronic technology environment</td>
</tr>
<tr>
<td>Well organised, progressive trade bodies</td>
</tr>
<tr>
<td>Management professionalism</td>
</tr>
<tr>
<td>Well-developed central services</td>
</tr>
<tr>
<td>Diversification of products and services</td>
</tr>
<tr>
<td>Products and services based on market rate structures</td>
</tr>
<tr>
<td>Emphasis on economic viability and long-term sustainability</td>
</tr>
<tr>
<td>Rigorous financial management of operations</td>
</tr>
<tr>
<td>Well functioning deposit insurance mechanism</td>
</tr>
</tbody>
</table>

Table B.1 - Stages in Credit Union Development

*Source: McKillop et al (2006), Credit Unions in Ireland: Structure, Performance & Governance, Institute of Chartered Accountants in Ireland, pp. 45, 46 (Table 2.1)*
APPENDIX C

Geographic Location of Industry Types (2006)

<table>
<thead>
<tr>
<th>Country/Region</th>
<th>No. of Credit Unions</th>
<th>Membership ('000)</th>
<th>Assets (US$ Million)</th>
<th>Penetration %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mature Credit Unions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S</td>
<td>8,536</td>
<td>87,389</td>
<td>726,208</td>
<td>43.18</td>
</tr>
<tr>
<td>Canada</td>
<td>1,068</td>
<td>10,975</td>
<td>200,393</td>
<td>47.52</td>
</tr>
<tr>
<td>Australia</td>
<td>144</td>
<td>3,500</td>
<td>29,605</td>
<td>25.91</td>
</tr>
<tr>
<td>France (^1)</td>
<td>1,066</td>
<td>4,766</td>
<td>21,236</td>
<td>13.67</td>
</tr>
<tr>
<td>Korea</td>
<td>1,027</td>
<td>4,680</td>
<td>27,957</td>
<td>13.24</td>
</tr>
<tr>
<td>Transitional Credit Unions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kenya</td>
<td>2,993</td>
<td>3,265</td>
<td>2,146</td>
<td>16.01</td>
</tr>
<tr>
<td>Ireland (^2)</td>
<td>525</td>
<td>3,050</td>
<td>19,921</td>
<td>109.98</td>
</tr>
<tr>
<td>New Zealand</td>
<td>39</td>
<td>176</td>
<td>410</td>
<td>6.37</td>
</tr>
<tr>
<td>Thailand</td>
<td>1,979</td>
<td>2,626</td>
<td>19,127</td>
<td>5.76</td>
</tr>
<tr>
<td>Latin America</td>
<td>2,330</td>
<td>13,895</td>
<td>22,778</td>
<td>4.52</td>
</tr>
<tr>
<td>Nascent Credit Unions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Great Britain</td>
<td>540</td>
<td>543</td>
<td>977</td>
<td>1.33</td>
</tr>
<tr>
<td>Russia</td>
<td>238</td>
<td>366</td>
<td>246</td>
<td>0.37</td>
</tr>
<tr>
<td>Fiji</td>
<td>46</td>
<td>19</td>
<td>30</td>
<td>3.20</td>
</tr>
<tr>
<td>Ukraine</td>
<td>760</td>
<td>1,790</td>
<td>615</td>
<td>5.55</td>
</tr>
<tr>
<td>Poland</td>
<td>70</td>
<td>1,550</td>
<td>2,053</td>
<td>5.66</td>
</tr>
</tbody>
</table>

\(^1\) Figures for France taken from 2004. Equivalent for 2006 not available in WOCCU Statistical Report as France is not a member.

\(^2\) The high penetration rate is explained by the existence of multiple memberships by adults in more than one credit union/ or by youth accounts.

Table C.1 - Geographic location of industry types

## APPENDIX D

### List of Authorised Investments for Credit Unions

<table>
<thead>
<tr>
<th>Class of Instrument</th>
<th>Description</th>
<th>Limits</th>
</tr>
</thead>
</table>
| 1. Irish and EMU State Securities | Transferable securities issued by the Irish State and other EMU States and traded on a regulated market. | (a) Max maturity = 10 years.  
(b) Max 30% in bonds maturing in 7+ years.  
(c) Aggregate must not exceed 70% of total investment portfolio. |
| 2. Accounts in Authorised Credit Institutions (Irish and Non-Irish based). | Interest bearing deposit accounts (or similar) in credit institutions authorised by the Financial Regulator or by another EMU State which has fulfilled the appropriate notification procedures to the Financial Regulator. | (a) Max maturity = 10 years.  
(b) Max 50% maturing in 5+ years.  
(c) Max 20% maturing in 7+ years.  
(d) The Credit Institution must have a long-term credit rating of “A” or above  
(e) Max 25% in one single Credit Institution. |
| 3. Bank Bonds | Bonds issued by Irish or non-Irish credit institutions as described in class 2 and traded on a regulated market. | (a) Max maturity date = 10 years.  
(b) Max 30% maturing in 7+ years.  
(c) The Credit Institution must have a long-term credit rating of “A” or above  
(d) Max 25% in one single Credit Institution.  
(e) Aggregate must not exceed 70% of total investment portfolio. |
| 4. Investment in Equities | Euro denominated equities traded on a regulated market within the EU. | (a) The issuer must have a min market capitalisation €1.5bn.  
(b) Total equities shall not exceed 5% of the total investment portfolio.  
(c) Max in a single equity = 1% of total investment portfolio. |
| 5. Collective Investment Schemes | Units or shares in open-ended retail collective investment schemes, other than property schemes, authorised by the Financial Regulator. | A credit union may invest in collective investment schemes if the underlying investments of the scheme are composed entirely of instruments falling within the definitions and limits of classes 1 to 4 above. |

*Table D.1 – Registrar of Credit Unions Guidance Note on Investments (2006)*
APPENDIX E

Draft Interview Question for Credit Union

1. Describe how investment risk is present in credit unions

2. Discuss how the level of investment risk has changed in recent times

3. Discuss the challenges in identifying/dealing with investment risk

4. Comment on possible external factors which have decreased/increased investment risk

5. Is the investment policy up to date/suitable to handle investment risk and how is it likely to be refined or developed?

6. Discuss how members of the investment committee are trained/inducted onto the committee

7. Discuss if the structure/composition of the investment committee today is suitable to deal with investing requirements and investment risk

8. Outline the internal controls that are employed to handle investments and investment risk

9. With the complexity of investments in credit unions growing, do you believe the level of training and guidance from relevant bodies (e.g. Financial Regulator, ILCU etc.) is sufficient?

10. Are the limits outlined in the guidance notes suitable/complete for credit union investing?
11. When making investment recommendations, what are the main considerations the investment committee is conscious of?

12. How are investment recommendations presented in reporting to the Board?

13. What are the major changes in the way the credit union manages its investments today compared with 5 years ago.

14. Outline your credit union's accounting treatment for investments

15. Describe how often the investment portfolio is monitored/valued

16. Explain how the disclosure notes on investments has changed in the annual reports compared to the past

17. Do you believe the recent perpetual bond issues will impact on future disclosure requirements?

18. To what extent do you expect the disclosures to change on investments in future years?

19. What are the issues that need to be taken into account in deciding whether to adopt fair value or historic cost in accounting for investments?

20. From past experience, describe the main issues auditors have discussed when auditing investments

21. When investments will be audited in the future, explain what you feel will be the biggest issue credit unions will face?
22. Do you have any other issues/ comments that you would like to address?
APPENDIX F
Draft Interview Question for Financial Regulator

1. Discuss how investment risk has changed in credit unions

2. What are the causes for this risk?

3. Do you feel that credit unions encounter similar investment risk to other financial institutions? What are the differences and similarities?

4. How will investment risk change for credit unions in the future?

5. Describe the generic elements of investment management typically evident in a credit union

6. How capable are credit unions at mitigating and controlling investment risk?

7. Does the structure of the investment committee adequately support the management of investment risk and how might the structure be strengthened?

8. How do current investment limitations seek to assist the management of investment risk?
9. How do you monitor credit unions which can invest outside the limits of the guidance note?

10. Outline how credit unions report their investment positions to the Financial Regulator

11. Comment on current credit union disclosures on investments?

12. Do you think that effective disclosures will now change in light of recent investment issues?

13. What are the issues that need to be taken into account in deciding whether to adopt fair value or historic cost in accounting for investments?


15. What are the main issues auditors have commented on to the Financial Regulator regarding investments in credit unions?

16. What observations would you make regarding the audit of investments in credit unions in the future?

17. Do you have any other issues/ comments that you would like to address?
APPENDIX G
Draft Interview Question for Auditor

1. Comment on the differences between auditing a credit union and auditing other financial institutions

2. From your experience, how has investment risk generally changed in recent times?

3. More specifically, how has investment risk changed in credit unions?

4. Comment on the structure and composition of the investment committee in credit unions

5. How much reliance in general can be placed on internal controls in credit unions?

6. For investments in credit unions, what are the critical internal controls and what is the greatest potential for strengthening them?

7. In general, how adequate are the disclosures on investments made by credit unions?

8. Do you feel the disclosures adequately inform the user of the accounts of the risk involved with investments?
9. Do you believe that disclosure requirements will change in the future, in light of recent investment issues involving credit unions

10. What are the issues that need to be taken into account in deciding whether to adopt fair value or historic cost in accounting for investments?

11. Outline the issues faced on auditing perpetual bonds in credit unions

12. When auditing investments, what are the principle judgemental areas facing auditors?

13. How will the recent perpetual bond controversy affect the audit of investments generally in credit unions?

14. Do you feel there will be any future developments in the audit domain relating to investments in credit unions?

15. Characterise the effectiveness of management letter observations with respect to issues such as investments as a means of improving internal controls and financial reporting by credit unions

16. Do you have any other issues/ comments that you would like to address?
APPENDIX H

Draft Interview Question for Journalist

1. Describe how investment risk is present in credit unions

2. Discuss how the level of investment risk has changed in recent times

3. Do you feel that credit unions encounter similar investment risk to other financial institutions? What are the differences and similarities?

4. Comment on possible external factors which have decreased/increased investment risk

5. Comment on the weaknesses credit unions are exposed to in relation to investments.

6. Are the limits outlined in the guidance notes suitable/complete for credit union investing?

7. What are the major changes in the way the credit union manages its investments today compared with 5 years ago?

8. How capable are credit unions at mitigating and controlling investment risk?

9. Comment on the investment committee structure in a credit union

10. Do you think that effective disclosures for investments in the financial statements will now change in light of recent investment issues?
11. Outline the issues faced on auditing perpetual bonds in credit unions

12. When investments will be audited in the future, explain what you feel will be the biggest issue credit unions will face?

13. Do you have any other issues/ comments that you would like to address?
APPENDIX I

Extended Findings Chapter

5.1 Risk environment for investments in credit unions

5.1.1

...the broker and the product producers who dealt with the credit union were not exposed to risk.... the member was technically aware of risk, (but) they did not perceive themselves of being at risk. What you got was concentration of risk in the credit union. That risk didn’t matter all that much so long that the economy was benign. But this began to bite since the capital markets went into turmoil.... [FR]

And then went on to state:

....if you have shareholders....the funds which they provide....is deployed in two ways, one for loans and the other to invest. But they need to be remunerated on an equal basis- then you got a problem because the lending function returns about 9% per annum while the investments function returns only 2.5% or 3%. So you have these two unequal income streams....it tends to drive down the dividend.... Consequently they began to look at how they might boost their dividend....That lead to a situation where credit unions began to move from short-term into longer-term and....more exotic instruments and...it was only a matter of time before the damage became evident when the markets took a downturn....Suffice to say, credit unions found themselves to be the holders of investments instruments that were unsuitable [FR].
5.1.2

There is the expertise risk there in terms of the expertise of the individuals who are actually managing the portfolio to understand what they are doing and being able to appraise the advice they are getting [CU2].

5.2 Causes and sources of investment risk

5.2.1

....the amount under investment, and the complexity of the investments in which people are investing has certainly changed....credit unions are much better at attracting savings than getting out loans, the amounts that are being invested has certainly increased and I think the diversity has also expanded quiet considerably from what it was ten or fifteen years ago [CU2].

The main reason for the change is that the low interest rates have led credit unions to look for more sophisticated type products.... With interest rates so low in recent years, it has drove credit unions to other investment sources, and in some cases, one would imagine, they would not know a lot about them [CU1].

The level of investment risk is now more volatile since the global financial crises impacted....product offerings by institutions are becoming more complex [CU3].

....world markets and the US subprime repercussions have increased the risk [CU4].
Another problem is the independence of the type of advice that we get. There are a number of so called investment advisors.... they know a lot about your business and investments, but at the end of the day, they also are selling those products and the independence question has to be asked [CU1].

....the one thing that maybe they (credit unions) are falling down on, and it may be a difficulty in the industry in Ireland is does the credit union have an independent investment advisor? And probably not as they are relying on the investment managers that they are dealing with and that they have their products with [AD].

Most investment advisors are also associated with product producers....there are very few actual independent investment advisors that are fee based [FR].

CU2 noted some factors that have decreased investment risk. Regulation was seen as a factor. CU2 also explained that their portfolio is now being rolled-over and they are “reinvesting maturing funds” before highlighting:

....(because of) the credit squeeze that is going on at the moment, the return on short term deposits has moved up....

CU3 noted that as “products are typically 100% capital guaranteed”, investment risk has decreased. CU4, while attributing the US subprime repercussions as being a cause of
increasing risk, felt that “having this information about those things has decreased it”. CU4 also explained that the investment guidelines helped focus the portfolio in terms of diversification, hence decreasing risk also.

5.3 Investment committee structure, skills, and policy

5.3.1

I suppose it is a concern with credit unions in general, that all the Board and committees are all voluntary and if there was a very strong manager there, could that manager sway things?....we report to the Board as auditors so that is an extra protection that the Board have [AD].

....some have very good investment committees, but most credit unions do not. Most credit unions do not have the expertise to rate investment activity....they operate on the basis of trust, mostly in their relationships with their investment providers, particularly their investment brokers. This raises the question of misselling....credit unions if you want me to put it in colloquial terms are ‘sitting ducks’ for a hard sell [FR].

....I just don’t know if a broker relationship is appropriate for the level of business that is being given by credit unions [BJ].

5.3.2

CU1 felt that the credit union movements’ investment committee structure and composition is “appallingly poor in general....they don’t have the qualifications, background or the experience in a lot of cases” and highlighted how “certain boards would not have the level
of expertise you would want” to identify investment risk. CU3 felt that “the composition is ok for today and it is based on the talent pool that we have available but they work closely with and are guided by the investment advisors”. CU3 discussed how they have independent investment advisors and that it “provides additional assurance to the investment committee members”. CU4 discussed that “the composition is robust enough” but also stated that “we have fallen prey to deals in the past that haven’t proven lucrative”.

5.3.3

....we’ve updated it this year. It covers the key areas like the counterparty risk, compliance risk, the regulatory guidance, who can sign, how a decision is made, it covers all the key areas....I think it’s fairly up to date and it covers all it needs to [CU1].

....yes it is, we revised it last Friday.... Is it suitable to handle investment risk? I suppose the best judge of that is we’ve had IFRSA (the Financial Regulator) around in the past two months and there was no major negative findings.... [CU2]

We see the investment policy as what you call a living document. It is updated annually or as often as deemed necessary....it is best....if the policies are not really prescriptive in detail....the policy will evolve with the changing circumstances [CU3].

It is not up to date. It is more at a draft stage but I’d say it will be able to handle the investment risk when completed [CU4].
5.3.4

...they (training events) are the lowest common denominator, they’re not specialised, they’re not focused.... [CU1].

....the training....is targeted at a lower level of expertise, and we do not get much from the training in relation to investments [CU2].

I would question whether it is an appropriate use of resources....I wouldn’t think training would turn an ordinary person into an investment expert [FR].

However, CU3 commented on how they received training “provided by an external expert” and feel it adds value and commented:

We make sure that it is presented in a manner that is fully understandable and that they have enough basic knowledge to be able to understand the particular products that are presented to them [CU3].

5.3.5

I think it should be based on the risks of credit union investments and how sophisticated the credit unions have become. I think there are competencies that are needed for general risks in the market place which should become minimum competencies for directors [CU1].

....there is absolutely a need for the people to have the required level of expertise or certainly have them as part of the Board [CU2].
.... we would like to see that the Boards of credit unions are subject to a fitness and probity regime which protects the interest of members...managed by people who are appropriately qualified, whether by experience or formally....[FR].

....my feeling would be that they should set themselves the highest possible standards....you can have a the grandfather rule where existing members are exempt and when new directors are co-opted, then they would subjected to the new rules....I think if consumers were aware of the lower standards tolerated in some areas of the credit union movement, they mightn’t be very happy [BJ].

I would hope it would change because it is an amateur organisation and without criticising the individuals, the structure of the credit union makes it amateur....from a management point of view, it doesn’t divest the proper responsibilities of the professionals....I can’t see it happening in the short-term because the organisation is too institutionalised. I can’t see people who have been working in the organisation for twenty, thirty, or forty years all of a sudden wanting to comply with the new regulations [CU4].

5.3.6

Risk and return would be the main one....another one is the proper spread of investments in terms of counterparties and maturity dates as well as the types of products [CU1].

Key issues would be security, liquidity, and yield....exposure to counterparty risk....we look at the guarantees....the ratings of those institutions [CU2].

....compliance with the policy....is the product completely understood by all present in the meeting....diversification as to financial institution, the duration of the investment....also then to make sure liquidity requirements are met [CU3].
....first and foremost is it capital guaranteed....the second thing is the interest rate and the third thing is the institutional risk. They don’t seem to be particularly bothered by that. They look at it like a national thing from a national perspective [CU4].

5.4 Investment guidelines

5.4.1

....if a credit union meet x number of criteria they can qualify to make certain investments.... if you meet eighteen standards and there is twenty standards you have more discretion, if you only meet fourteen you have less discretion, if you meet five you get very little discretion....[CU1]

....I think where a Board doesn’t have the expertise....I think IFSRA (the Financial Regulator) should be in a position to prescribe that you cannot do certain investments [CU2].

....it is worth thinking about, but one of things about the credit union movement generally....is they want to have a one-size fits all situation for everything. So uniformity of treatment is one of key principles. If you go the route suggested....that puts it up to us to evaluate the probity of their investment committee, a task which is not easy. I wouldn’t like to suggest it. And....because of the nature of the capital markets, it would probably undermine the value of the investment guidelines if too many exceptions are made [FR].
5.4.2

The only thing that it might allow us do is invest in insurance products. That’s the one thing that we’ve done very successfully in the past that we are unable to do anymore, perhaps in the future [CU1].

….it is a very onerous application process and it seems to me to be structured to deter credit unions from going down that road [CU3].

….they don’t say what expertise you need and how do you prove it?….we’ve probably figured we haven’t got enough training [CU4].

5.4.3

They (credit unions) think that regulatory interventions are designed in some way to damage them or that they’re inspired by competitors who don’t have their best interests at heart….they sometimes forget that some of the regulatory intervention is designed to protect members and consumers and that they should take those concerns on board [BJ].

Wearing my journalist hat, that was a big red flag. When the referee comes out jumping all over the participants in the match and accusing them of breaking the rules then you have to say to yourself if something if going on there? [BJ]
5.6 Valuation of investments

5.6.1

Lower of cost and net realisable value. We don’t show gains that are not guaranteed [CU1].

....deposits would be at cost....corporate bonds and government bonds would be accounted for at market value, equities are accounted for at the lower of cost and market value, trackers would be accounted for at capital guaranteed value, and income would be accounted for when locked in....[CU2]

Investments are stated at the lower of cost or market value. Investment income is accounted for in the following manner; dividends from quoted or unquoted investments are accounted for on the date when the shares first becomes ex dividend, interest on fixed interest securities is accounted for when the interest is payable under the terms of the issue of the securities, interest income on notes and deposits is accounted for as it accrues, and income on with-profit bonds and other similar investments is recognised to the extent that it is guaranteed or locked in [CU3].

....what we want to see are that investments are valued at the lower of cost and net realisable value and ideally only the gains that are realised are brought in [FR].

5.6.2

The difficulty with perpetual bonds is what is the market value?....because these types of bonds are more uncertain than other types of bonds, they tend to be less traded....when you get your market value you accept it based on cost, if lower than cost, bring in the lower value and then hit the P&L. What would tend to happen if you can’t get a market value after the year end? You would ask the
investment manager to get independent quotes from brokers as to their assessment as to what the market value is. Now if that needed to be done, you would have to assess exactly who the broker is, is he independent, and has he put some form of reasonable thought into how he came up with his price. But that could be an issue [AD].

....we’ve been told by an accountant recently....their view is that perpetual bonds should be valued at a multiple of the income generated rather that necessarily what they’re trading at [CU1].

AD’s response was opposed to this:

....if that was the absolute only thing you get to work out your market value at the year end, we’d have to assess it. But we will be looking for all of the alternatives before we go down that route. That would be a last resort.

5.6.3

....we want to go back to a much more conservative basis. Some credit unions went a little step too far....by changing their accounting policies to introduce ‘so called’ fair value accounting. Fair value accounting is wonderful while your investments are going up but it really hurts you when your investments are going down. The whole concept of fair value accounting is now under threat internationally with regards the whole capital market situation [FR].

....the Credit Union Act....Section 110, states that investments must be valued at cost or market value if it’s lower. It basically says to take a prudent approach....the Act itself and the section strays on the prudent side, you would assume that they (credit union regulators) are going to go with it and that they are not going to take up fair value accounting. There would be too many ups and downs in the accounts from one year to the next, whereas doing it on the prudent approach where you actually disclose at cost or market value if lower than cost, then that would be a more prudent approach to take [AD].
5.6.4

....it is also the practice of credit unions....in respect of the interest returned on the loans, to bring it in only when it is received, you can never accrue it. However a practice started in the investments that brought in unrealised gains (on investments)....So consequentially, within the same set of accounts there was two conflicting accounting policies and that lead to a situation where credit unions in some cases were paying dividends out on unrealised income, a situation which we would be very unhappy with....[FR]

The regulator seems to be taking a view recently....that unless you’re actually receiving the income into your hand within a year, that it shouldn’t be accounted for. We would take the view that if there is a minimum guarantee over a period, just say a seven year product with 21%, why can’t we lock in? Why can’t we account for 3% this year, 3% next year, and 3% the year after? It makes absolute sense to us [CU1].

5.7 Investment disclosures in the financial statements

5.7.1

This is a difficult one. They are actually complying with the guidance out there which basically doesn’t say an awful lot. They are just showing the cost or whatever valuation method they are using for investments....they are not breaking down the investments by product or by type or by maturity date or anything like that....I’m assuming that banks and other financial institutions have more onerous disclosure responsibility and that they have to break down things like that, but with credit unions, the requirements aren’t there yet. Maybe they will come [AD].
And later stated in relation to expected future Guidance Notes:

"...you would assume the disclosures for investments will become more rigorous than they are at the minute but we will wait and see."

5.7.2

*I think it will....we are looking at a 40% write down....it will have a material impact and I think it is appropriate that it should be disclosed....[CU2]*

*I think the accounting bodies, maybe it’s not their responsibility, but perhaps in their own interest to come together and to find the basic disclosures.... [CU1]*

*I suppose credit unions may have to explain in detail any significant movements in valuation and perhaps the existence of such products in the portfolio because they certainly do fall outside the Guidance Notes issued....[CU3]*

5.9 Future audit issues

5.9.1

"....I think one of the things we want to improve with the audits is to raise them to a higher quality level. We had some issues with auditors....Some we would have questions about [FR]."
....I think for a number of credit unions, and it’s probably going to come to light this year, is the valuation of investments at market value as opposed to cost....they will be forced to write down this year....the other issue is....how credit unions value investments for both capital and income....[CU2]

....there are many products out there that credit unions have invested in that there are virtually no markets for. It’s going to be an issue what the market value is for those instruments. The key point is can the product be reliable measured in the view of auditors for them to provide the appropriate assurances to the members [CU3].
APPENDIX J

Sample of Credit Union Disclosure Notes on Investments

Credit Union 2
Investment Committee Report- Yes

Extract of Disclosure Note:

1.2 Income Recognition

...Investment Income is recognised on an accruals basis.

1.4 Investments

Investments are stated at cost, market value and locked-in value, as appropriate.

Credit Union 3
Investment Committee Report – No

Extract of Disclosure Note:

Investments

Investments are stated at the lower of cost or market value.

Investment income

Investment income is accounted for as follows:-

- dividends from quoted and unquoted investments are accounted for on the date when the shares first becomes ex dividend.
- interest on fixed interest securities is accounted for when the interest is payable under the terms of issue of the securities.
- interest income on notes and deposits is accounted for as it accrues.
- income on “with profit bonds” (and similar investments) is recognised to the extent that it is guaranteed

Interest earned on cash held by the investment managers is shown as part of the income for the year.