## I. PURPOSE

Examiners must review management systems to ensure proper disclosure and valuation of assets, and accurate and timely recognition of expenses of Other Real Estate Owned (OREO) over the three phases of the asset's life cycle: acquisition, holding period, and disposition.

## II. PRIMARY REFERENCES

1. Michigan Credit Union Act
   a. Section 342 (4)(j) and (5)
   b. Section 382
   c. Section 401 (d)(e) and (jj)
2. Accounting Standards Codification (ASC) 310 and 360 provide guidance for the initial recording of foreclosed assets. (Specific references include: 310-10-45-3, 310-40-40-6, 310-40-35-7, 310-40-40-2 through 40-4 and 40-8, 310-40-55-10A)
3. Accounting Standards Codification (ASC) subtopic 970-340 provides general guidance on accounting for costs during a development and construction period.
4. Accounting Standards Codification (ASC) subtopic 835-20 provides guidance on capitalization of interest costs, if applicable.
5. Accounting Standards Codification (ASC) 360-20 provides guidance on accounting for sales of OREO properties.
6. Accounting Standards Update (ASU) 2014-04 "Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure."

## III. MINIMUM PROCEDURES

1. **Disclosure/Reporting**
   Foreclosed and Repossessed Assets must be classified as a separate balance sheet amount or included in other assets on the Balance Sheet with separate disclosure in the notes to the financial statements. (ASC 310-10-45-3)
2. **Acquisition**
   a. A real estate loan becomes an OREO when a credit union receives physical possession resulting from an in-substance repossession or foreclosure.
   b. ASC 310-40-55-10A clarifies when a credit union is considered to have received physical possession of the property, which is upon the occurrence of one of the following:

i. The creditor obtains legal title to the residential real estate property upon completion of a foreclosure. A creditor may obtain legal title to the residential real estate property even if the borrower has redemption rights that provide the borrower with a legal right for a period of time after a foreclosure to reclaim the real estate property by paying certain amounts specified by law.

ii. The borrower conveys all interest in the residential real estate property to the creditor to satisfy the loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The deed in lieu of foreclosure or similar legal agreement is completed when agreed-upon terms and conditions have been satisfied by both the borrower and the creditor.

**d.** When a loan is moved to the OREO account, the asset must be recorded at the lesser of carrying amount (loan balance) or fair value less cost to sell (net realizable value). (ASC 310-40-35-7 & 360-10-35-43)

i. The difference between the principle value of the loan and the cost basis must be written off to the Allowance for Loan and Lease Losses Account.

ii. If the net realizable value exceeds the carrying amount (loan balance), the difference should be charged-off through the Allowance for Loan and Lease Losses Account.

**3. Holding Period**

**a.** The OREO should be classified as Held for Sale if it meets the following criteria, per ASC 360-10-45-9:

i. Management, having the authority to approve the action, commits to a plan to sell the asset.

ii. The asset is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets.

iii. An active program to locate a buyer and other actions required to complete the plan to sell the asset have been initiated.

iv. The sale of the asset is probable, and transfer of the asset is expected to qualify for recognition as a completed sale, within one year, except as permitted by ASC 360-10-45-11.

v. The asset is being actively marketed for sale at a price that is reasonable in relation to its current fair value. The price at which a long-lived asset is being marketed is indicative of whether the entity currently has the intent and ability to sell the asset.

vi. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

**b.** Subsequent to acquisition and transfer, the OREO must be carried at the lower of cost or fair value, less estimated costs to sell. Documentation should be maintained supporting the property's carrying value.

**c.** During the holding period, the valuation of the OREO may have to be adjusted to the lower of carrying amount or updated fair value (less cost to sell).

**d.** Subsequent valuations resulting in a gain or loss must be accounted for by adjusting the carrying amount of the asset. Gains/losses resulting from an adjustment are to be charged through a gain/loss account, not through the Allowance for Loan and Lease Losses (ALLL) Account. A gain for any subsequent increase in fair value less cost to sell may be recognized, but not in excess of the cumulative loss previously recognized. (ASC 360-10-35-40)

**e.** Upkeep expenses such as utilities, maintenance, and property taxes incurred during the holding period must be recognized as a non-operating expense on the income statement. Depreciation expense may not be recognized on assets held for sale. ASC subtopic 970-340 permits certain expenses incurred during the completion of a project to be capitalized.

**4. Disposition**

**a.** ASC 360-20-40-7 describes the conditions that must be met for a transaction to qualify as a sale:

- **i.** The parties are bound by the terms of a contract;
- **ii.** All consideration has been exchanged;
- **iii.** Any permanent financing for which the seller is responsible has been arranged, and;
- **iv.** All conditions precedent to closing have been performed.

**b.** A transaction need only qualify as a sale under GAAP as described in ASC 360-20-40-7 to transfer the asset out of OREO, even when the seller finances 100 percent of the purchase price.

**c.** The disposition of an OREO must be recorded in one of five methods allowed by ASC 360-20:

- **i.** Full accrual
- **ii.** Installment
- **iii.** Cost Recovery
- **iv.** Reduced-Profit
- **v.** Deposit

d. If a profit (gain) is involved in the sale of the real estate, each method establishes the manner in which the profit is to be recognized. Regardless of which method is used, any losses on the disposition of real estate must be recognized immediately.
e. Gain or loss on disposition is recorded on the income statement.
f. Full accrual method is often used in sale of assets because it is recorded as a sale. To use the full accrual method, the following four conditions are to be met:
   i. A sale has been consummated;
   ii. Buyer's initial investment (down payment) and continuing investment (periodic payments) are adequate to demonstrate a commitment to pay for the property;
   iii. The receivable is not subject to future subordination, and;
   iv. The usual risks and rewards of ownership have been transferred.
g. Guidelines for the minimum down payment that must be made for a transaction to qualify for the full accrual method are described in ASC 360-20-55-2, appendix A. These vary from five percent to twenty-five percent of the property's sales value.

**5. Policy & Procedures**

a. The OREO Policy should, at a minimum, address the following:
   i. When a foreclosed asset is transferred to the OREO account;
   ii. Standard valuation method used to obtain fair value at transfer;
   iii. Standard costs to sell utilized in net realizable value calculation;
   iv. Subsequent valuation methods used to update fair value;
   v. Frequency of subsequent valuations;
   vi. Responsible people/positions for maintaining portfolio and accounting;
   vii. Accounting requirements for the acquisition, holding, and disposition phases;
   viii. Property management standards (payment of utilities, taxes, and insurance as well as maintenance);
   ix. Required documentation to be maintained in files; and
   x. Action plan to sell property.
b. Files should be maintained with all critical information pertaining to each individual property, including but not limited to: valuation information, proof of current insurance, verification of current property taxes, listing agreement with realtor, invoices for work performed, multiple bids on renovation work, and documentation supporting all expenses incurred (utilities, lawn care, snow plow, etc.).

**c.** Sound management systems must be in place to ensure appropriate property management practices are implemented and monitored.