

# ACUIA

## 23<sup>rd</sup> Annual Conference

# Understanding Financial Statements

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# Getting the Most Out of Your Financial Statements

## Workshop Objectives

- ▶ Become familiar with the basic rules governing financial reporting for credit unions.
- ▶ Understand the key elements of the credit union's balance sheet and income statement.
- ▶ Learn to calculate and interpret the credit union's key financial statement ratios.
- ▶ Analytical review – can help you develop “good questions” to ask about the credit union's financial performance.
- ▶ Highlights of NCUA Call Report and Financial Performance Reports (FPRs).



# Board of Director/Management Responsibilities for Financial Reporting

NCUA Regulation – Part 741.6

- ❑ Ensure that financial statements are prepared in accordance with generally accepted accounting principles (GAAP).
- ❑ Ensure that accounting records/financial reports are prepared timely and accurately.



# Director Duties Regarding Financials

## NCUA Regulation Part 701.4



### What a Director Should Know

At a minimum, a director should be able to examine the credit union's balance sheet, income statement and be able to answer the following questions:

- What does this line item mean?
- Why is it important to the credit union?
- Is the value of the line item changing over time? If so, what does that change (either positive or negative) mean?
- Is the change important to the credit union?



# Supervisory/Audit Committee Responsibilities for Financial Reporting

## NCUA Regulation – Part 715, Basic Responsibilities

Board of Directors and Management:

- 1) Meet required **financial reporting objectives**
- 2) Establish practices and procedures sufficient to safeguard members' assets



# Supervisory/Audit Committee Responsibilities for Financial Reporting

## NCUA Regulation – Part 715, Specific Responsibilities

To carry out the Basic responsibilities, the Supervisory Committee must determine whether:

- 1) Internal controls are established and effectively maintained
- 2) Accounting records and **financial reports** are promptly and accurately prepared
- 3) The policies and control procedures established by the Board are properly administered
- 4) Policies and control procedures are sufficient to safeguard against error, conflict of interest, self dealing, and fraud

# Supervisory/Audit Committee Responsibilities for Financial Reporting

## NCUA Rules and Regulations – Part 715, Mandates

In carrying out these **Basic** and **Specific** responsibilities, the Supervisory Committee must:

- 1) Ensure that filing requirements for (**Call Reports**) are met
- 2) Perform or obtain an Audit (as defined by regulation)
- 3) Perform or obtain a Verification of Members' Accounts
- 4) Act to avoid sanctions for failure to comply with these requirements



# Financial Reporting Requirements for Credit Unions

- ❑ Statement of Financial Condition = Balance Sheet
- ❑ Statement of Income
- ❑ Statement of Comprehensive Income
- ❑ Statement of Members' Equity
- ❑ Statement of Cash Flows
- ❑ Notes to the Financial Statements
- ❑ Call Reports (Regulatory Reporting)

**REQUIRED**



# Understanding the Financial Statements



# Main Street Federal Credit Union

## Statements of Financial Condition

<b>Assets:</b>	<b>As of June 30, 2013</b>	<b>As of June 30, 2012</b>	<b>\$ Change</b>	<b>% Change</b>
Cash	\$ 2,625,000	\$ 1,650,000	\$ 975,000	100.00%
Investments	78,000,000	72,000,000	6,000,000	8.33%
Loans to members, net (see note 1)	215,375,000	201,350,000	15,025,000	7.46%
Prepaid and other assets	1,000,000	1,500,000	(500,000)	-33.33%
Other real estate owned (OREO)	3,000,000	500,000	2,500,000	500.00%
<b>Total assets</b>	<u>\$ 300,000,000</u>	<u>\$ 276,000,000</u>	<u>\$ 24,000,000</u>	8.70%
 <b>Liabilities:</b>				
Members' share & savings accounts	\$ 276,000,000	\$ 252,500,000	23,500,000	9.31%
Accounts payable and accrued liabilities	2,350,000	2,500,000	(150,000)	-6.00%
Borrowed funds	1,000,000	1,000,000	-	0.00%
<b>Total liabilities</b>	279,350,000	256,000,000	23,350,000	9.12%
 <b>Members' Equity:</b>				
Regular reserve	2,500,000	2,500,000	-	0.00%
Undivided earnings	19,400,000	18,500,000	900,000	4.86%
Accumulated other comprehensive loss	(1,250,000)	(1,000,000)	(250,000)	25.00%
<b>Total members' equity</b>	<u>20,650,000</u>	<u>20,000,000</u>	<u>650,000</u>	3.25%
<b>Total liabilities &amp; members' equity</b>	<u>\$ 300,000,000</u>	<u>\$ 276,000,000</u>	<u>\$ 24,000,000</u>	8.70%

# Note 1: Loans to Members

<b><i>Loans outstanding</i></b>	<b><u>June 30, 2013</u></b>		<b><u>June 30, 2012</u></b>	
Real estate	\$	175,000,000	\$	163,500,000
Vehicle		25,500,000		23,000,000
Unsecured		<u>15,500,000</u>		<u>14,500,000</u>
Gross loans to members		216,000,000		201,000,000
Less: allowance for loan losses		<u>(625,000)</u>		<u>(650,000)</u>
<b>Loans to members, net</b>	\$	<b><u>215,375,000</u></b>	\$	<b><u>200,350,000</u></b>

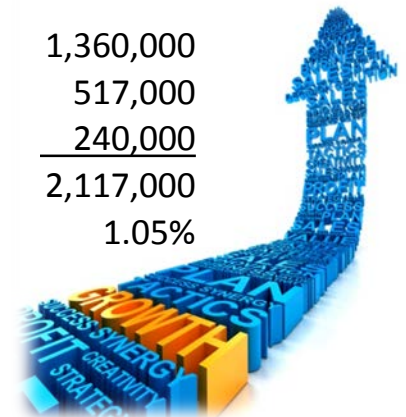
## ***Summary of allowance activity***

Balance, beginning of year	\$	650,000	\$	400,000
Provision for loan losses		750,000		1,250,000
Recoveries		100,000		150,000
Loans charged off		<u>(875,000)</u>		<u>(1,150,000)</u>
Balance, end of year	\$	625,000	\$	650,000

## ***Reportable Delinquencies from Call Report:***

2 - 6 months	\$	2,000,000	\$	1,360,000
6 - 12 months		2,900,000		517,000
over 12 months		<u>1,067,500</u>		<u>240,000</u>
	\$	5,967,500	\$	2,117,000

***Reportable Delinquency to Gross Loans*** 2.75% 1.05%



# Main Street Federal Credit Union

## Statements of Income

	For the years ended				ROA
	June 30, 2013	June 30, 2012	2013 ROA	2012 ROA	Impact
Interest income	\$ 11,000,000	\$ 11,000,000	3.82	4.14	(0.32)
Interest expense	( 1,750,000)	1,500,000	(0.61)	(0.56)	(0.05)
Net Interest margin	9,250,000	9,500,000	3.21	3.58	(0.37)
Provision for loan losses (PLL)	(750,000)	(1,250,000)	(0.26)	(0.47)	0.21
Net interest income after PLL	8,500,000	8,250,000	2.95	3.11	(0.09)
Non-interest income	7,000,000	7,250,000	2.43	2.73	(0.30)
Non-interest expense	(13,600,000)	(14,250,000)	(4.72)	(5.37)	0.65
<b>Net income</b>	<b>\$ 1,900,000</b>	<b>\$ 1,250,000</b>	<b>0.66</b>	<b>0.47</b>	<b>0.19</b>



# Understanding the Statement of Financial Condition = Balance Sheet



- ▶ **Two Basic Points:**
- ▶ The balance sheet is prepared for a specific day.....not a period of time. This is usually prepared monthly – As of June 30, 2013, etc.
  - Accounting equation = Assets – Liabilities = Equity
- ▶ **Assets** = Represents things the Credit Union owns.
- ▶ **Liabilities** = Represents things the Credit Union owes to third parties.
- ▶ **Members' Equity** = Mathematical difference between Assets and Liabilities.

# Understanding the Statement of Financial Condition = Balance Sheet

- ▶ **Assets** = cash on hand; cash in banks; investments; loans to members; accrued interest receivable; property and equipment; prepaid assets; and NCUSIF deposit.
- ▶ **Liabilities** = members' deposits; borrowed funds; interest payable; accounts payable; and accrued liabilities.
- ▶ **Members' Equity** = undivided earnings; regular reserve; appropriated undivided earnings; accumulated other comprehensive income/(loss); and equity acquired through merger/acquisition.



# Understanding the Statement of Income



- ▶ **One Basic Point:**
  - The statement of income is prepared for a period of time.....not for a specific day. This is usually prepared monthly – For the month ended June 30, 2013; For the quarter ended June 30, 2013; for the six months ended June 30, 2013, etc.
- ▶ **Revenues** = Represents income earned from assets and services.
- ▶ **Expenses** = Represents costs incurred on liabilities and services provided for and by the credit union.
- ▶ **Net Income/(Loss)** = Mathematical difference between Revenues and Expenses.



# Understanding the Statement of Income

## Net Income/(Loss):

- At the end of each accounting period, the credit union's net income or loss is added to or subtracted from the credit union's undivided earnings balance.
- Inadequate net income over a prolonged period or a material net loss in any period could erode the credit union's net worth and result in serious regulatory intervention, including conservatorship.





# Key Balance Sheet Ratios

## Loan to Share Ratio:

(gross outstanding loans divided by outstanding deposits)

- $\$216,000,000 / \$276,000,000 = 78.3\%$

## Loan to Assets Ratio:

(gross outstanding loans divided by total assets)

- $\$216,000,000 / \$300,000,000 = 72.0\%$

## What These Ratios Mean:

- The portion of members' deposits or total assets that have been invested in loans to members.
- A low ratio may indicate strict lending policies, low risk tolerance, or unattractive loan products.
- A high ratio may indicate attractive loan products, higher risk tolerance, or strong marketing programs.



# Key Balance Sheet Ratios



## Loan Portfolio Mix:

June 30, 2013

- Real Estate:  $\$175,000,000 / \$216,000,000 = 81.0\%$
- Vehicle:  $\$25,000,000 / \$216,000,000 = 11.6\%$
- Unsecured:  $\$16,000,000 / \$216,000,000 = 7.4\%$

## What You Should Know:

- What are the key characteristics and challenges of each type of loan portfolio segment? (Real estate loans = lower yield)
- Are there any concentration risks?
- Is the Credit Union effectively managing the loan portfolio mix?

# Key Balance Sheet Ratios



## Delinquent Loan Ratio:

(delinquent loans > 2 months divided by total loans)

- $\$5,947,000 / \$216,000,000 = 2.76\%$  - as of June 30, 2013
- $\$2,117,000 / \$201,000,000 = 1.05\%$  - as of June 30, 2012

## What This Ratio Means:

- This ratio indicates a credit union's current credit risk associated within the loan portfolio.
- A low ratio may indicate that underwriting practices are very conservative or that uncollectible loans are charged off timely.
- A high ratio may indicate that uncollectible loans are not charged off timely, the collection department is understaffed or poor credit decisions were made 12 – 18 months earlier.

# Key Balance Sheet Ratios

## Delinquent Loan Mix:

<u>Category</u>	<u>June 30, 2013</u>	<u>June 30, 2012</u>
2 – 6 months	33%	64%
6 – 12 months	49%	25%
Over 12 months	18%	11%

## What You Should Know:

- What is the credit union's charge off policy? Are loans being charged off timely?
- What percentage of delinquency over 6-12 months result in losses? Is this factored into the Allowance for Loan Losses (ALL) Reserve?
- How is the underlying collateral being evaluated?



# Key Balance Sheet Ratios

## Net Charge-off Ratio:

(charge-offs minus recoveries divided by average loans outstanding)

$$\$675,000 / (\$216,000,000 + \$201,000,000) / 2 = 0.32\%$$

## What This Ratio Means:

- This ratio indicates the annualized percentage of net charge-offs recognized by a credit union in relation to its average balance of outstanding loans during the same period.
- A low ratio may indicate that underwriting practices are very conservative or that uncollectible loans are not being charged off timely.
- A high ratio may indicate that uncollectible loans are excessive, underwriting standards are poor, or collection efforts are weak.



# Key Balance Sheet Ratios

## Allowance to Delinquent Loans:

(ALL balance divided by delinquent loans > 2 months)

- $\$625,000 / \$5,947,000 = 10.4\%$  - as of June 30, 2013
- $\$650,000 / \$2,117,000 = 30.7\%$  - as of June 30, 2012

## What This Ratio Means:

- This ratio indicates the relationship between current ALL reserves and non-performing delinquent loans.

## What You Should Know:

- Why didn't the ALL increase when delinquency significantly increased?
- What is the composition of delinquent loans (well-collateralized)?

# Key Balance Sheet Ratios



## Net Worth Ratio:

(regular reserve plus undivided earnings divided by total assets)

- $\$2,500,000 + \$19,400,000 = \$21,900,000 / \$300,000,000 = 7.30\%$

## What This Ratio Means:

- This ratio measures the credit union's financial strength in terms of its retained earnings to total assets.
- A low ratio usually indicates that net income has not been sufficient to keep pace with the growth in total assets and/or credit union management is ineffective.
- A high ratio usually indicates that net income has been strong over the years and/or credit union management is effective.

# The Importance of Net Worth Ratios

## Prompt Corrective Action (PCA)

- Well capitalized = 7% or greater
- Adequately capitalized = 6% to 6.99%
- **Undercapitalized** = 4% to 5.99%
- **Significantly undercapitalized** = 2% to 3.99%
- **Critically undercapitalized** = less than 2%



# Net Worth Ratio – Total Asset Options

## Total Asset Options:

- Quarter-end option.
- Average of the current and three preceding calendar quarter-end balances.
- Average of the three month-end balances over the calendar quarter.
- Average of daily assets over the calendar quarter.

## What You Should Know:

- Which asset option does your credit union use?
- Do they frequently change options to attain optimal ratios?
- Are they using an alternative method to remain at a higher PCA level?

# Key Income Statement Ratios

**Return on Assets Ratio:** (net income/loss divided by average total assets)

$$\$1,900,000 / (\$300,000,000 + \$276,000,000) / 2 = 0.66\%$$

	For the years ended		2013 ROA	2012 ROA	ROA Impact
	June 30, 2013	June 30, 2012			
Interest income	\$ 11,000,000	\$ 11,000,000	3.82	4.14	(0.32)
Interest expense	1,750,000	1,500,000	(0.61)	(0.56)	(0.05)
Net Interest margin	9,250,000	9,500,000	3.21	3.58	(0.37)
Provision for loan losses (PLL)	750,000	1,250,000	(0.26)	(0.47)	0.21
Net interest income after PLL	8,500,000	8,250,000	2.95	3.11	(0.09)
Non-interest income	7,000,000	7,250,000	2.43	2.73	(0.30)
Non-interest expense	13,600,000	14,250,000	(4.72)	(5.37)	0.65
<b>Net income</b>	<b>\$ 1,900,000</b>	<b>\$ 1,250,000</b>	<b>0.66</b>	<b>0.47</b>	<b>0.19</b>

## What This Ratio Means:

- This ratio indicates how profitable a credit union is relative to its total average assets.
- This ratio indicates how well management is using credit union assets to generate net income.

# Key Income Statement Ratios

## Net Interest Margin Ratio:

(interest income – interest expense divided by average total assets)

$$\$9,250,000 / (\$300,000,000 + \$276,000,000) / 2 = 3.21\%$$

## What This Ratio Means:

- This ratio indicates the relationship of interest income earned on loans and investments versus interest paid on members' deposits and borrowed funds. The net interest margin provides the primary resource to support the credit union's operating expenses and provision for loan losses expense.

## What You Should Know:

- ▶ The Asset Liability (ALCO) Committee is responsible for managing balance sheet risk, including setting interest rates on loans, as well as deciding what to pay on dividends.
- ▶ Which members of management and/or the Board participate on the ALCO Committee?

# Key Income Statement Ratios

## Provision for Loan Losses Ratio:

(provision for loan losses expense divided by average total assets)

$$\$750,000 / (\$300,000,000 + \$276,000,000) / 2 = 0.26\%$$

## What This Ratio Means:

- ▶ This ratio represents the amount charged to the income statement to fund the ALL to cover incurred losses within the loan portfolio
- ▶ When loan charge-offs and delinquency are increasing, the provision for loan losses expense and ratio will usually increase (directionally consistent).



# CAMEL Rating System

## Primarily Based on Key Ratios

C – Capital (also known as members' equity, net worth)

A – Asset quality (includes delinquencies, charge-offs)

M – Management (subjective rating)

E – Earnings (Net income or ROA)

L – Asset/Liability Management

- Used by regulators to rate credit unions on overall soundness
- Rating system is 1 to 5 with 1 being the most sound



# Outside Sources for Credit Union Data

- ▶ NCUA Letter To Credit Unions – State of the CU Industry
- ▶ Quarterly Call Reports – NCUA website
- ▶ Financial Performance Report (FPR) – quarterly report from NCUA provides historical and peer information
- ▶ NCUA's Peer Groups
  - < \$2 million
  - \$2 million to < \$10 million
  - \$10 million to < \$50 million
  - \$50 million to < \$100 million
  - \$100 million to < \$500 million
  - \$500 million and greater



National Credit  
Union Administration

# Financial Performance Report - Ratio Analysis

## Capital Adequacy

	2008	2009	2010	2011	2012	2013	Peer Average
Net worth/total assets	9.27%	8.39%	8.25%	8.86%	7.61%	7.30%	10.54%

## Asset Quality

	2008	2009	2010	2011	2012	2013	Peer Average
Delinquent loans/totals loans	1.93%	1.56%	1.76%	1.25%	1.05%	2.75%	1.17%
Net charge-offs/average loans	0.83%	2.18%	1.83%	1.67%	0.42%	0.32%	0.64%

## Asset/Liability Management

	2008	2009	2010	2011	2012	2013	Peer Average
Total loans/total shares	74.74%	69.36%	83.96%	84.33%	79.60%	78.26%	65.64%
Total loans/total assets	68.40%	63.12%	76.89%	77.12%	72.83%	72.00%	57.60%

# Financial Performance Report - Ratio Analysis

## Earnings

	2008	2009	2010	2011	2012	2013	Peer Average
Return on average assets (ROA)	0.19%	-0.67%	-0.41%	0.44%	0.47%	0.66%	0.62%
Interest income/average assets	5.30%	4.90%	4.56%	4.35%	4.14%	3.82%	3.74%
Cost of funds/average assets	1.80%	1.48%	0.97%	0.65%	0.56%	0.61%	0.60%
Provision for loan losses/average assets	0.80%	1.61%	1.44%	0.70%	0.47%	0.26%	0.33%
Operating expenses/average assets	5.22%	5.24%	5.30%	5.34%	5.37%	4.72%	3.71%
Non-interest income/average assets	2.71%	2.76%	2.74%	2.78%	2.73%	2.43%	1.52%



# Possible Questions to Ask from Your Analytical Review



## Allowance for Loan Losses:

- Why is the credit union's ALL balance as of June 30, 2013 lower than it was as of June 30, 2012, when gross loans to members increased and delinquency has more than doubled?
- Why are the credit union's recovery payments on charged-off loans down \$50,000 (33.3%) this year (\$100,000) versus last year (\$150,000)?
- Is management adhering to the credit union's charge-off policy?

# Possible Questions to Ask from Your Analytical Review



## Other Real Estate Owned (OREO):

Why did our real estate foreclosures increase so dramatically (From \$500,000 to \$2,500,000 = 500%) between years?

Are these foreclosures still part of the credit union's reportable delinquency?

How many additional foreclosures does the credit union expect in the next six months?

What are the expected losses on the foreclosures the credit union currently owns?

How does the credit union market these properties for sale?

# Possible Problems Identified

## ▶ Allowance for Loan Losses:

Management did not provide an adequate loan loss reserve to address the significant increase in loan delinquency and the escalating number of foreclosures. A closer review of these trends disclosed that the collections department was severely understaffed and operating without a competent collections manager for more than 9 months. This error overstated loans to members, net income and undivided earnings by \$2,000,000.

## ▶ Other Real Estate Owned (OREO):

Foreclosed property was transferred to OREO at the outstanding loan balance versus the fair value of the property. This error overstated assets, net income and undivided earnings by \$1,500,000.





# Financial Impact of Identified Problems

## ▶ Net Income/ROA Ratio:

- Originally reported \$1,900,000 in retained earnings and ROA of 0.66%
- After adjustments, net income became a net loss of (\$1,600,000) and a negative ROA of (0.55%)

## ▶ Retained Earnings/Net Worth Ratio:

- Originally reported \$21,900,000 in retained earnings and net worth ratio of 7.30% = well capitalized
- After adjustments, retained earnings became \$18,400,000 and net worth ratio became 6.13% = adequately capitalized

# Call Reporting Requirements for Credit Unions

## The Call Report - What is Included:

- ❑ Statement of Financial Condition
- ❑ Statement of Income and Expense
- ❑ Miscellaneous Information
- ❑ Delinquent Loans by Collateral Type
- ❑ Additional Delinquency Information
- ❑ Loan Charge Offs and Recoveries
- ❑ Liquidity, Commitments and Sources



# Call Reporting Requirements for Credit Unions

## The Call Report - What is Included:

- ❑ PCA Net Worth Calculation Worksheet
- ❑ Specialized Lending
  - Indirect Loans
  - Real Estate
  - Loans Purchased and Sold
  - Business Lending
- ❑ Investments, Supplemental Information
- ❑ Credit Union Service Organizations (CUSOs)



# Common Call Report Errors

## □ Issues:

- Balance Sheet - Lines 27(a) and (b) - OREO and REPO assets not reported separately
- Miscellaneous Information – Line 5 – Aggregate amount of future capital and operating lease payments on fixed assets shown as zero
- Loan Charge-offs and Recoveries – Line 8 – Totals do not reconcile to activity in the Credit Union’s ALL account
- Liquidity, Commitments and Sources – Line 2 (d) – Overdraft protection program commitments often incorrect or shown as zero
- Liquidity, Commitments and Sources – Line 7 (a) – Total lines of credit - often incorrect or excluding a new line of credit

# OPEN FORUM

## Other Issues and Your Questions



# Speaker Information

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