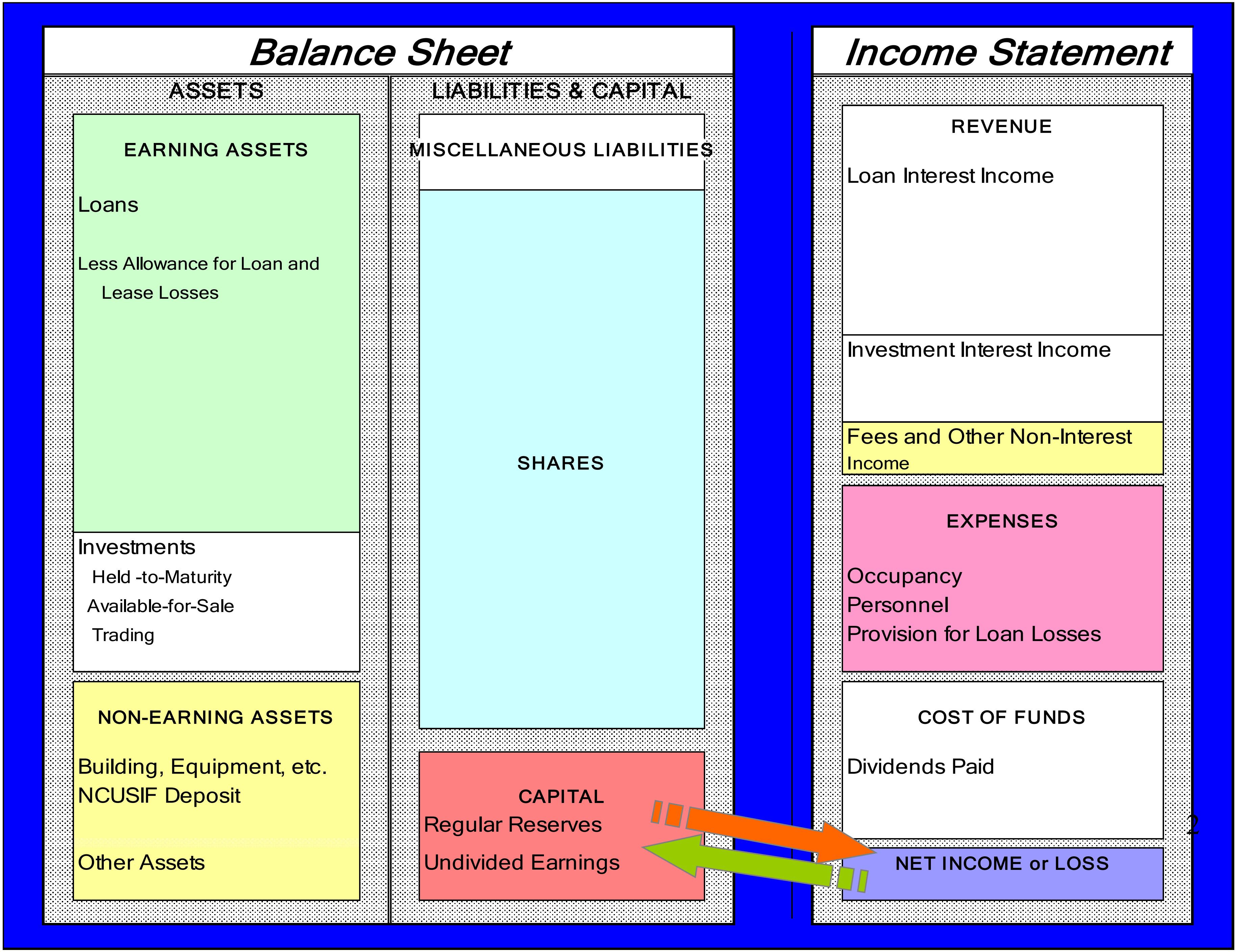
What All Directors Need to Know About Financial Statements

By Tim Harrington, CPA

TIM Touch Inspire Motivate


Balance Sheet
ASSETS
EARNING ASSETS
Loans
Less Allowance for Loan and Lease Losses
Investments
Held -to-Maturity
Available-for-Sale
Trading
NON-EARNING ASSETS
Building, Equipment, etc.
NCUSIF Deposit
Other Assets
LIABILITIES & CAPITAL
MISCELLANEOUS LIABILITIES
SHARES
CAPITAL
Regular Reserves
Undivided Earnings
Income Statement
REVENUE
Loan Interest Income
Investment Interest Income
Fees and Other Non-Interest Income
EXPENSES
Occupancy
Personnel
Provision for Loan Losses
COST OF FUNDS
Dividends Paid
NET INCOME or LOSS

Balance Sheet

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What You Have

LIABILITIES & CAPITAL

MISCELLANEOUS LIABILITIES

What You Owe

SHARES

CAPITAL

Regular Reserves

Undivided Earnings

What Your Members Own

Income Statement

REVENUE

Loan Interest Income

Investment Interest Income

Fees and Other Non-Interest Income

What Comes In

EXPENSES

Occupancy
Personnel
Provision for Loan Losses

COST OF FUNDS

Dividends Paid

What Goes Out

NET INCOME or LOSS

Balance Sheet

ASSETS

EARNING ASSETS

Cash	$ 160,000
LOANS	
Unsecured	1,350,000
Vehicle	3,500,000
Real estate	300,000
Total loans	5,150,000
Less allowance	(101,875)
Net Loans	5,048,125

INVESTMENTS

Held to maturity	3,500,000
Avail for sale	441,875
TOTAL	3,941,875

NON-EARNING ASSETS

Property and equip	150,000
NCUSIF	200,000
Other N. E. assets	
Other assets	500,000

TOTAL ASSETS $ 10,000,000

LIABILITIES & CAPITAL

MISCELLANEOUS LIABS

Miscellaneous Liabs	$ 151,000

SHARES

Share savings	1,680,000
Share drafts	3,500,000
Money market	3,624,000
IRAs	41,000
Other	4,000
Total Shares	8,849,000

CAPITAL

Regular reserve	80,000
Undivided earn	920,000
Reserve for Investment losses	
Total Capital	1,000,000

TOTAL LIABS & CAP $ 10,000,000

Income Statement

REVENUE

INTEREST INCOME

Loans	$ 563,400
Investments	200,400
Total Int Inc	763,800
Non Interest Inc	78,200
TOTAL	842,000

EXPENSES

Occupancy, Personnel	332,000
Provission for Loan Losses	44,000
TOTAL	376,000

COST OF FUNDS

Dividends Paid	364,000

NET INCOME

NET INCOME	$ 102,000

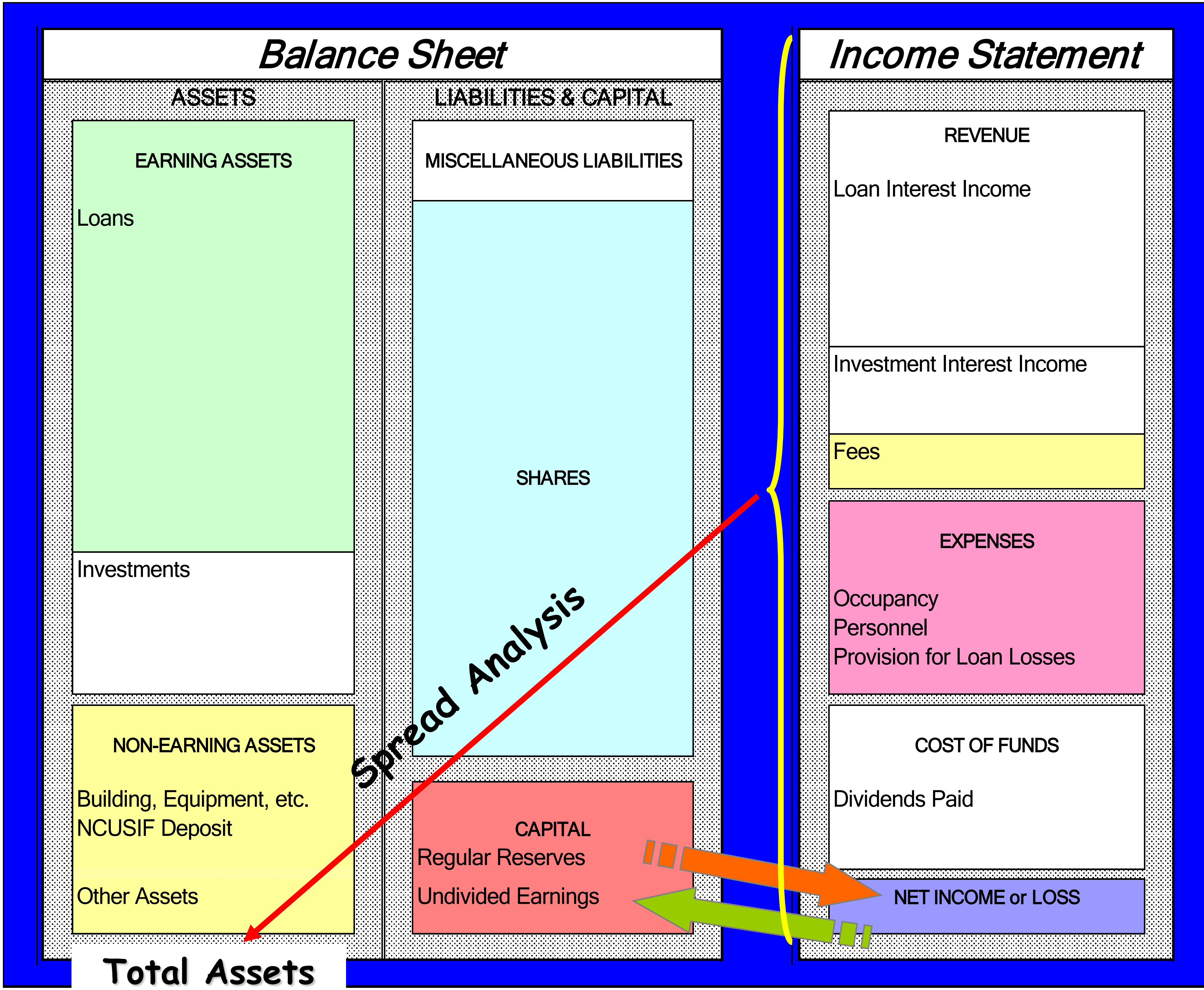
What are the most important items to watch?

Depends

- **But there are some <u>Basics</u>**
  - **ROA**
  - **Capital to Assets Ratio**
  - **Loan to Share Ratio**
  - **Delinquency and Charge-off Ratios**
  - **But if you have Areas of High Risk, you'll need more**
    - **Real estate**
    - **Indirect lending**
    - **Commercial (member business) lending**

Which CU is Doing Better? Why we use Comparable ratios

	10 Bil CU	10 Mil CU
Interest income	$ 496,000,000	563,000
Cost of funds	(175,000,000)	(164,000)
Net Interest Margin	321,000,000	399,000
Operating costs	(329,000,000)	(332,000)
Provision for loan losses	(111,000,000)	(44,000)
Net loss before other income	(120,000,000)	23,000
NII – Non-interest income (Fee income, Other)	136,000,000	78,000
Net Profit or Loss	$ 16,000,000	102,000
Total Capital	$ 500,000,000	$1,000,000



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NET INCOME or LOSS
Spread Analysis
Total Assets

Which CU is Doing Better? Why we use Comparable ratios

As a % of Average Assets		10 Bil CU	10 Mil CU
Yield: Interest income		4.96	5.63
Less:	Cost of funds	(1.75)	(1.64)
Net Interest Margin (NIM-Spread)		3.21	3.99
Less:	Operating costs	(3.29)	(3.32)
Less:	Provision for loan losses	(1.11)	(0.44)
Net loss before other income		(1.20)	0.23
Plus:	NII-Non-interest income (Fee income, Other)	1.36	0.78
Equals: Return on Assets (ROA)		0.16	1.02
Capital to Assets Ratio		5.00%	10.00%

Credit Union Profitability
ROA and Spread Analysis

Spread Analysis:

Simply dividing the Income Statement amounts by Average Assets

The ‘Banking’ Business

Credit unions make money 2 ways:

- Interest Income
- Non-Interest Income

Credit unions spend money 3 ways:

- Cost of Deposits (Cost of Funds)
- Operating Expenses (cost of people, buildings, and systems)
- Provision for Loan Losses (cost of bad loans)

Spread Analysis (ROA)
National Averages

As a % of Average Assets	12/30/14	12/31/97
Yield: Interest income	3.38	7.63
Less: Cost of funds	(0.54)	(3.64)
Net Interest Margin	2.84	3.99
Less: Operating costs	(3.11)	(3.32)
Less: Provision for loan losses	(0.28)	(0.44)
Net loss before other income	(0.55)	0.23
Plus: Non-interest income	1.35	0.78
Equals: Net Profit or Loss (ROA)	0.80	1.02

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What is Net Interest Margin?

Net Interest Margin (NIM)

- **AKA: Spread**
- You don’t control your Interest Income,
  - the Market does
- You don’t control you Interest Expense,
  - the Market does

You try to control the spread between the two:

NIM or Spread

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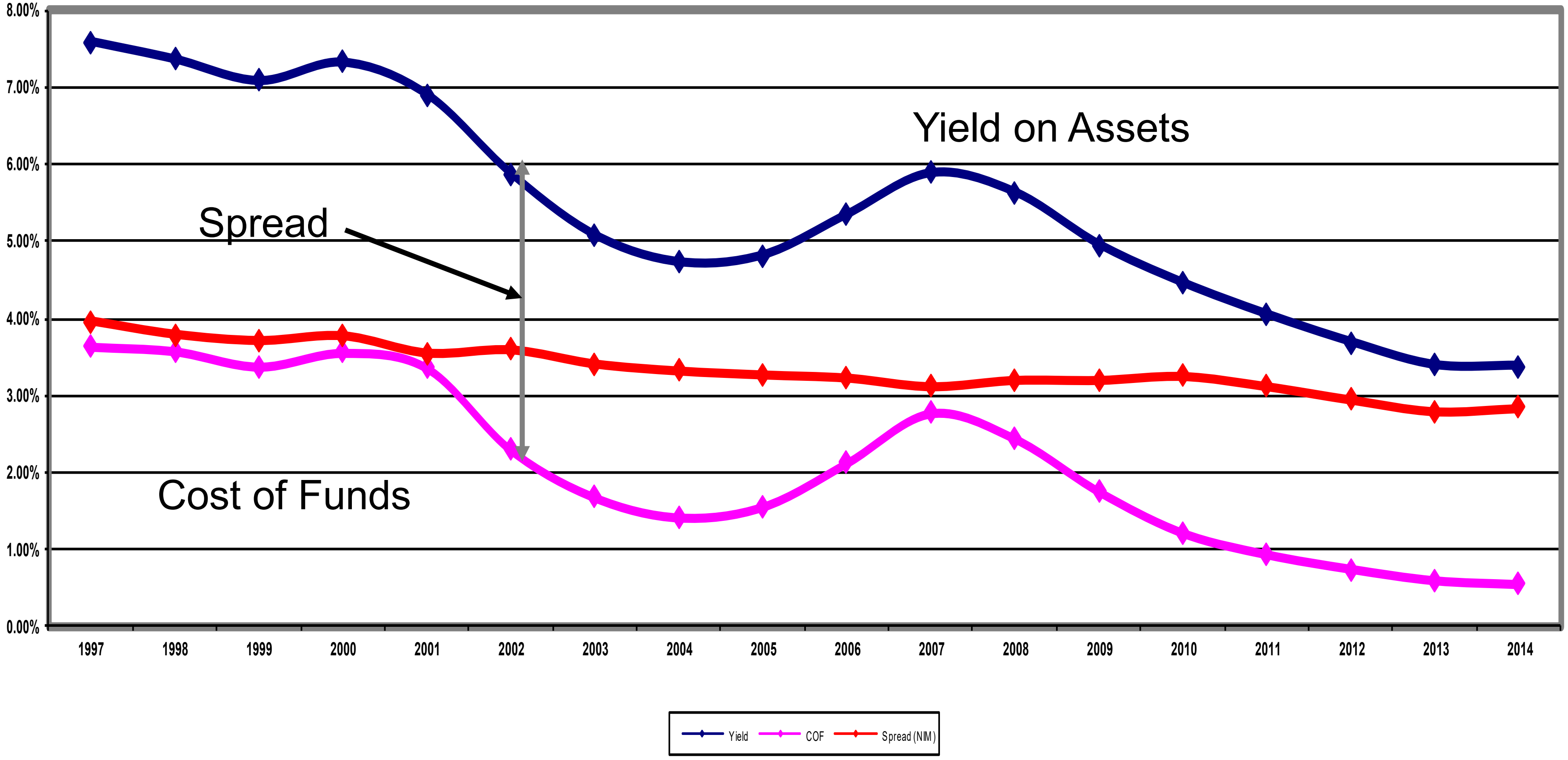
Spread or Net Interest Margin (NIM)

Goal: Can you keep it stable… or grow it?



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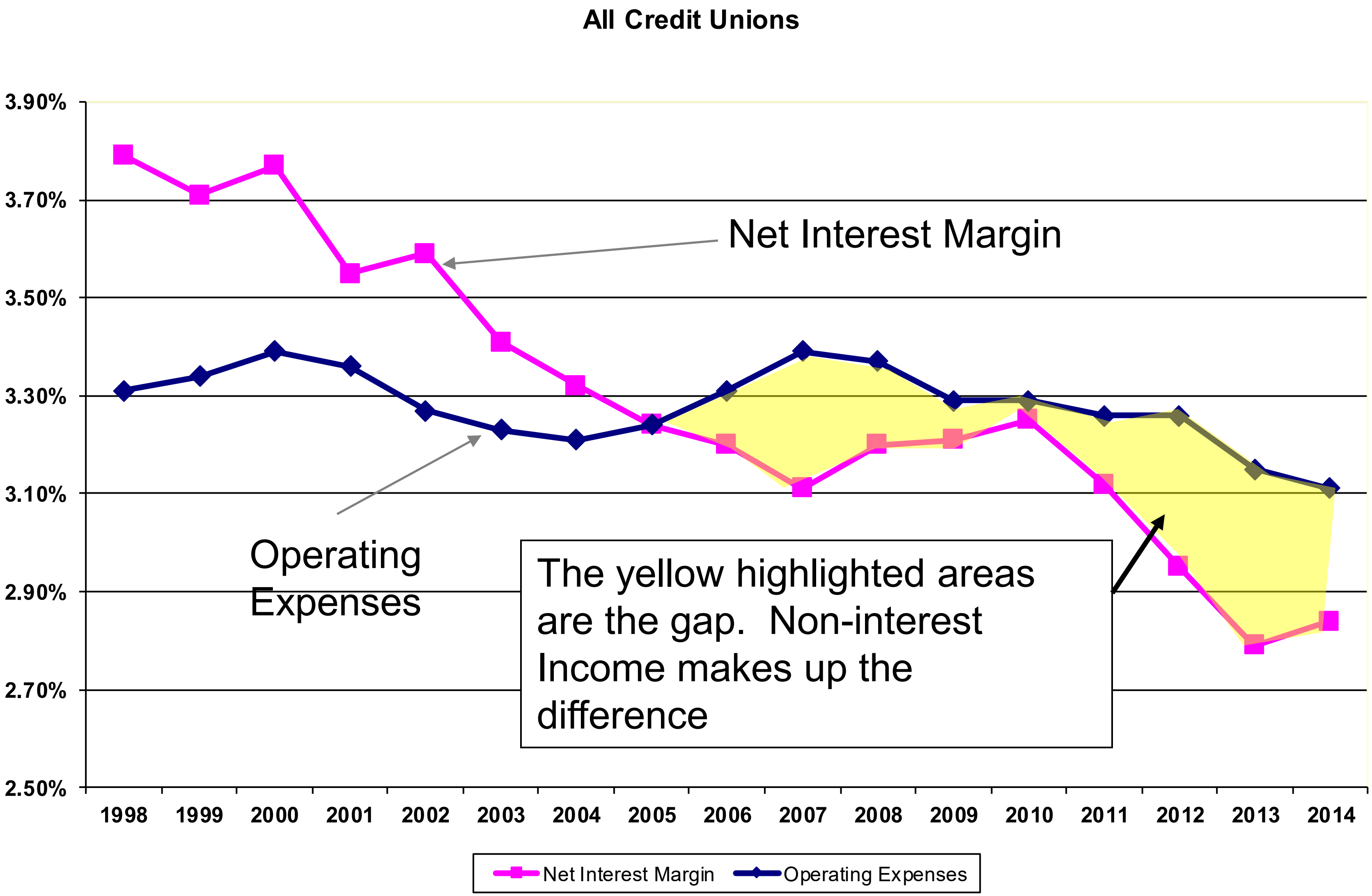
Net Interest Margin & Operating Expense Ratio



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Non-Interest Income
Not Just Fees!!!

- **Fee Income** – NSF and late loan fee
- **Service Revenues** – Overdraft Protection
- **Commission Income** – sales of something
- **Interchange Income** – Debit and Credit cards
- **Other Non-Interest Sources** – CUSO selling some product or service

Non-Interest Income (NII) Important?

Vital:

- Where a majority of CU profit is derived
- Has been growing in importance for decades
- Is more stable than other forms of income
- Causes less financial risk to the credit union when expanded

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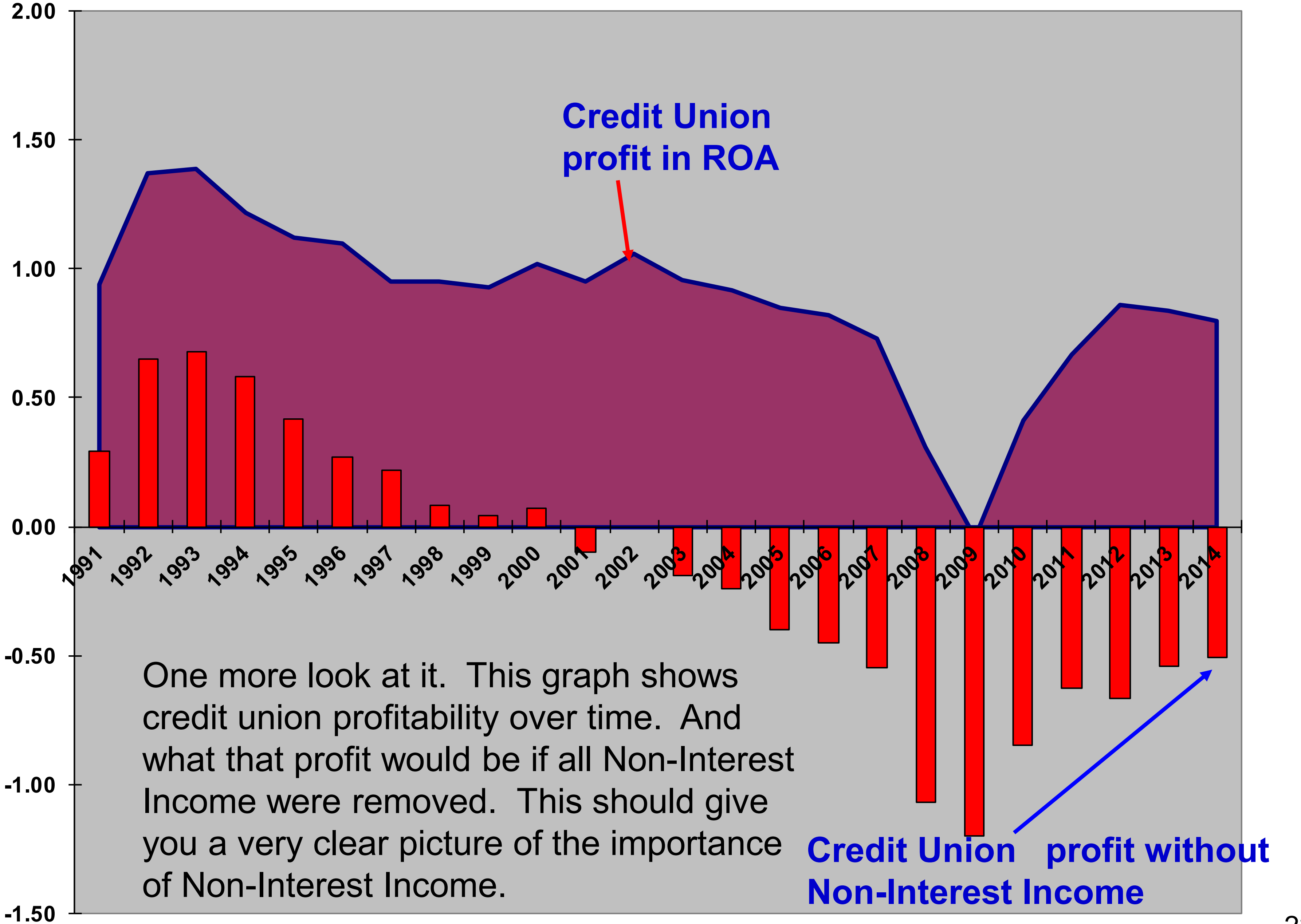

One more look at it. This graph shows credit union profitability over time. And what that profit would be if all Non-Interest Income were removed. This should give you a very clear picture of the importance of Non-Interest Income.

Spread Analysis (ROA) National Averages

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Plus: Non-interest income	1.35	0.78
Equals: Net Profit or Loss (ROA)	0.80	1.02

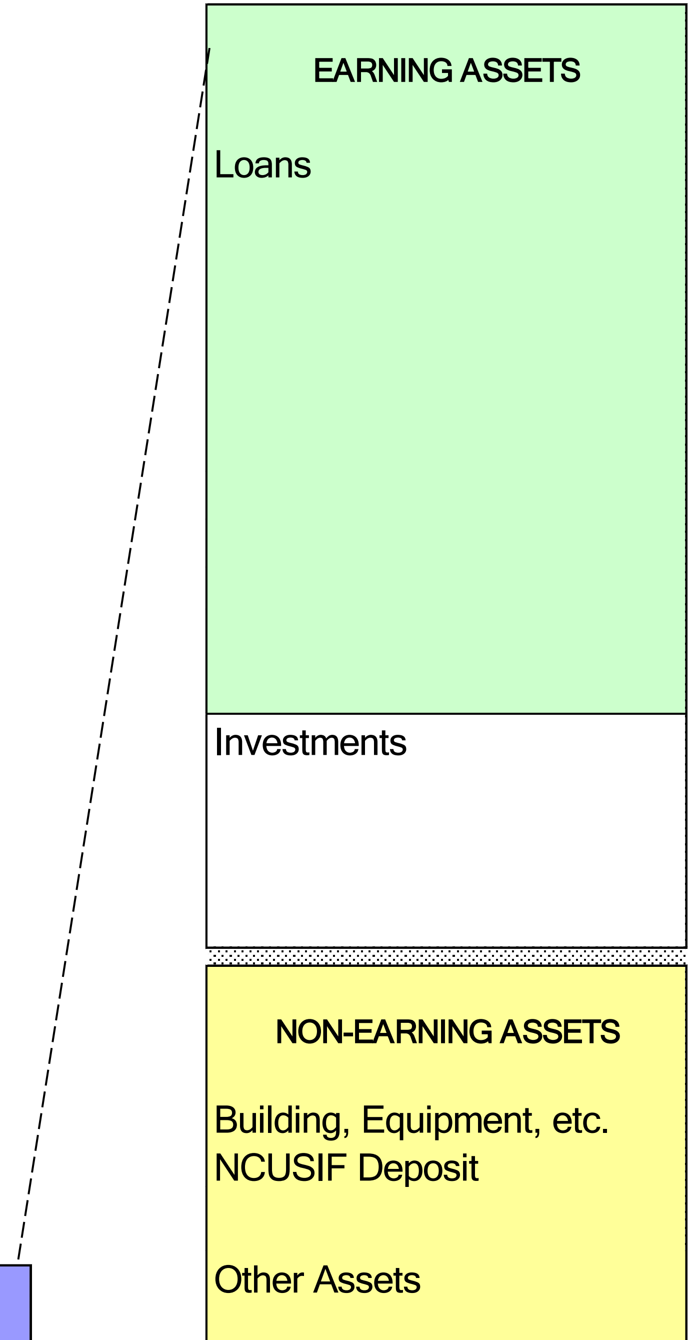
Return on Average Assets (ROAA or ROA)

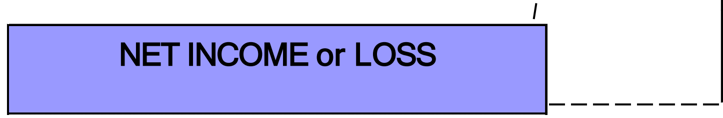
Net income / Average assets*

*Average assets = Total assets last period + Total assets this period / 2

Measures a credit union's profitability

National Average = 0.80%





Different Business Models
Different Spread Results
Know Your Model

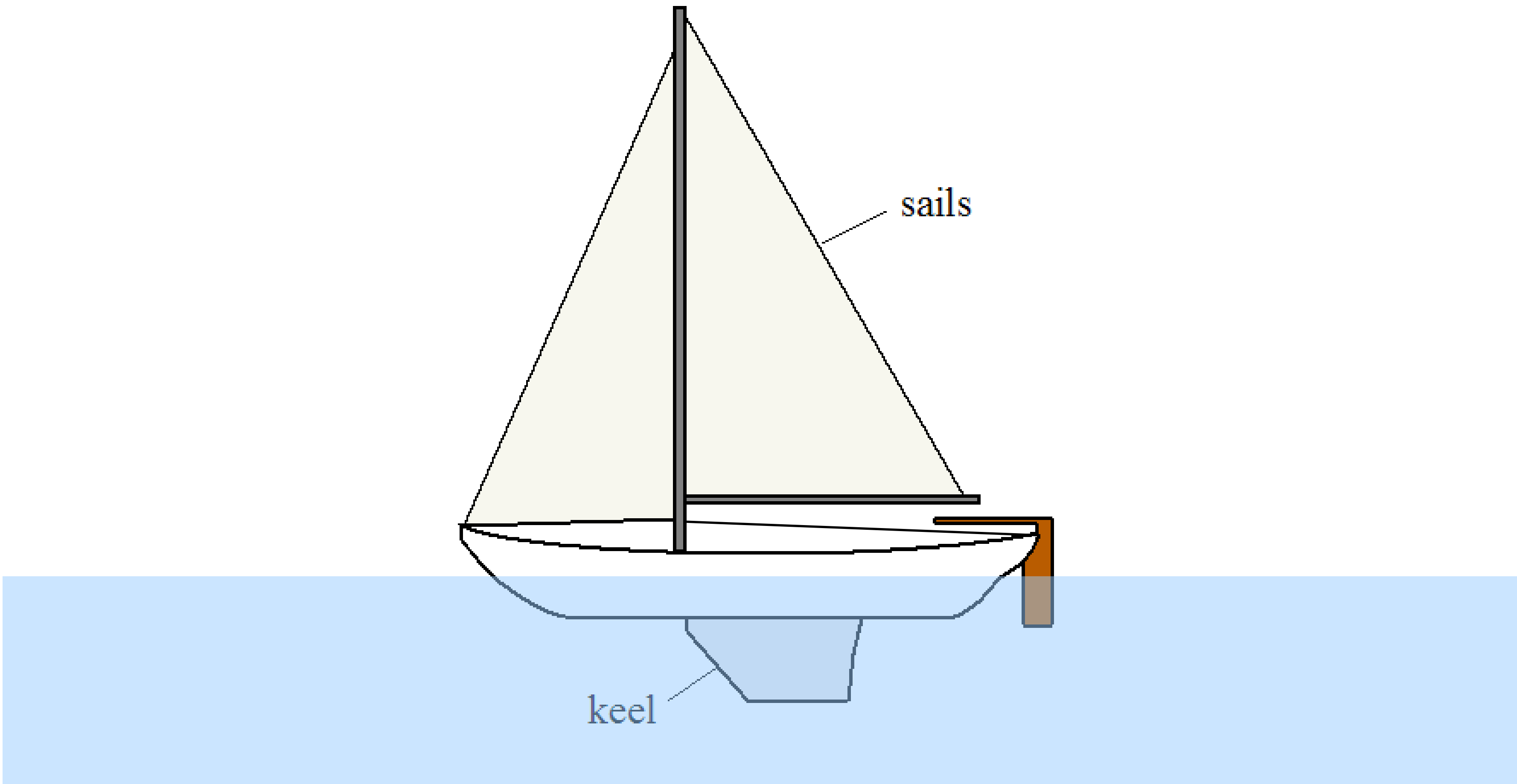
	Avg CU	MOMMs CU	Low Op CU
Yield	3.38	8.37	3.52
Cost of funds	(0.54)	(0.39)	(0.77)
NIM	2.84	7.98	2.75
Operating exp	(3.11)	(7.67)	(1.48)
PLL	(0.28)	(2.57)	(0.11)
Net before NII	(0.55)	(2.26)	1.16
Non-Interest Income	1.35	3.73	0.50
ROA	0.80	1.47	1.66
Capital/Assets	10.8%	10.5%	22%

What is Capital?

Capital is not cash

- It is the accumulated earnings and losses since you started the credit union.
- Tells you what portion of your assets belong to the member owners and what part is dedicated to creditors
- Your ‘rainy day’ fund
- Your ‘hibernation’ fat

If Assets grow and Capital doesn't keep up, the credit union becomes unstable

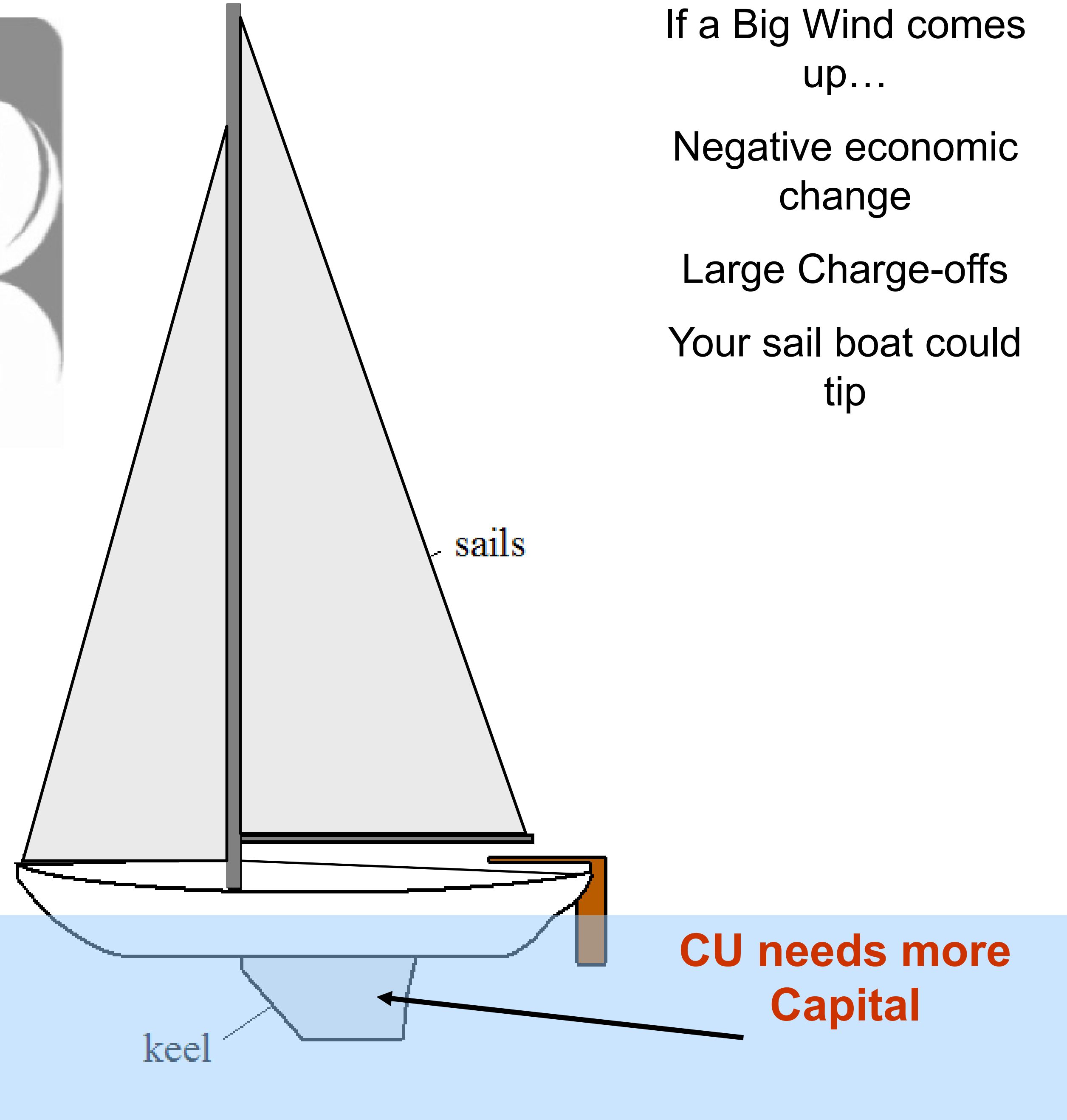


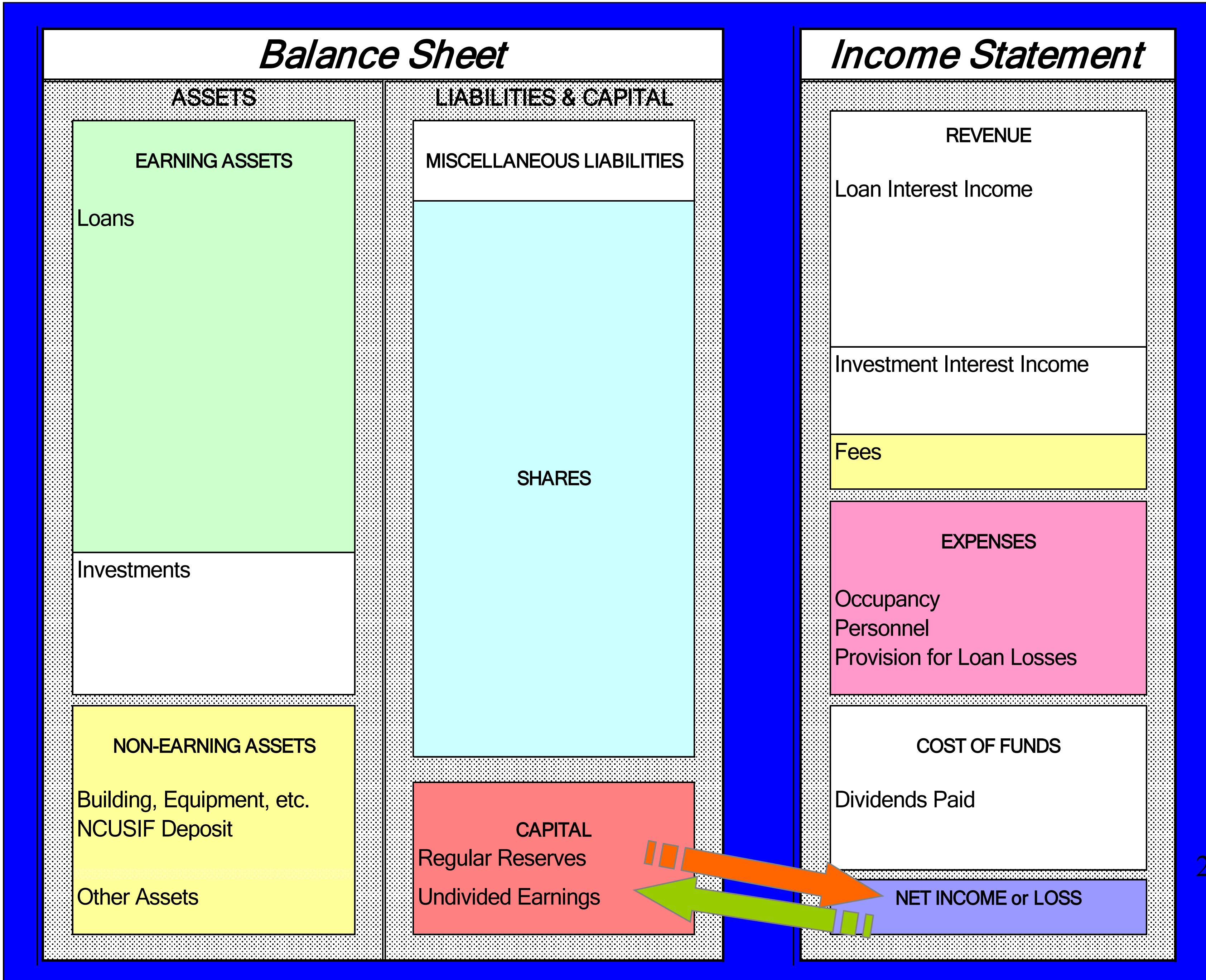
If a Big Wind comes up…

Negative economic change

Large Charge-offs

Your sail boat could tip

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Provision for Loan Losses
COST OF FUNDS
Dividends Paid
NET INCOME or LOSS

Balance Sheet

ASSETS

EARNING ASSETS	
Cash	$ 16,000
LOANS	
Unsecured	13,500
Vehicle	110,000
Real estate	30,000
Total loans	153,500
Less allowance	(1,100)
Net Loans	152,400

INVESTMENTS	
Held to maturity	50,000
Avail for sale	5,000
TOTAL	55,000
Less Allowance for Investment Losses	

NON-EARNING ASSETS	
Property and equip	1,500
NCUSIF	2,000
Other assets	100

TOTAL ASSETS	$ 227,000

LIABILITIES & CAPITAL

MISCELLANEOUS LIABS	
Miscellaneous Liabs	$ 15,100

SHARES	
Share savings	68,000
Share drafts	35,000
Money market	45,000
IRAs	41,000
CDs	4,000
Total Shares	193,000

CAPITAL	
Regular reserve	8,000
Undivided earn	10,900
Total Capital	18,900

TOTAL LIABS/CAP	$ 227,000

Income Statement

REVENUE	
INTEREST INCOME	
Loans	$11,000
Investments	1,500
TOTAL	12,500

COST OF FUNDS	
DIVDENDS PAID	4,200
Net Interest Income	8,300

EXPENSES	
Provision for Loan Losses	1,000
Occupancy	
Personnel	7,800
Systems	
TOTAL	8,800

NON-INTEREST INCOME	
Fee Income	700
Service Charges	800
Other Income	400
	1,900

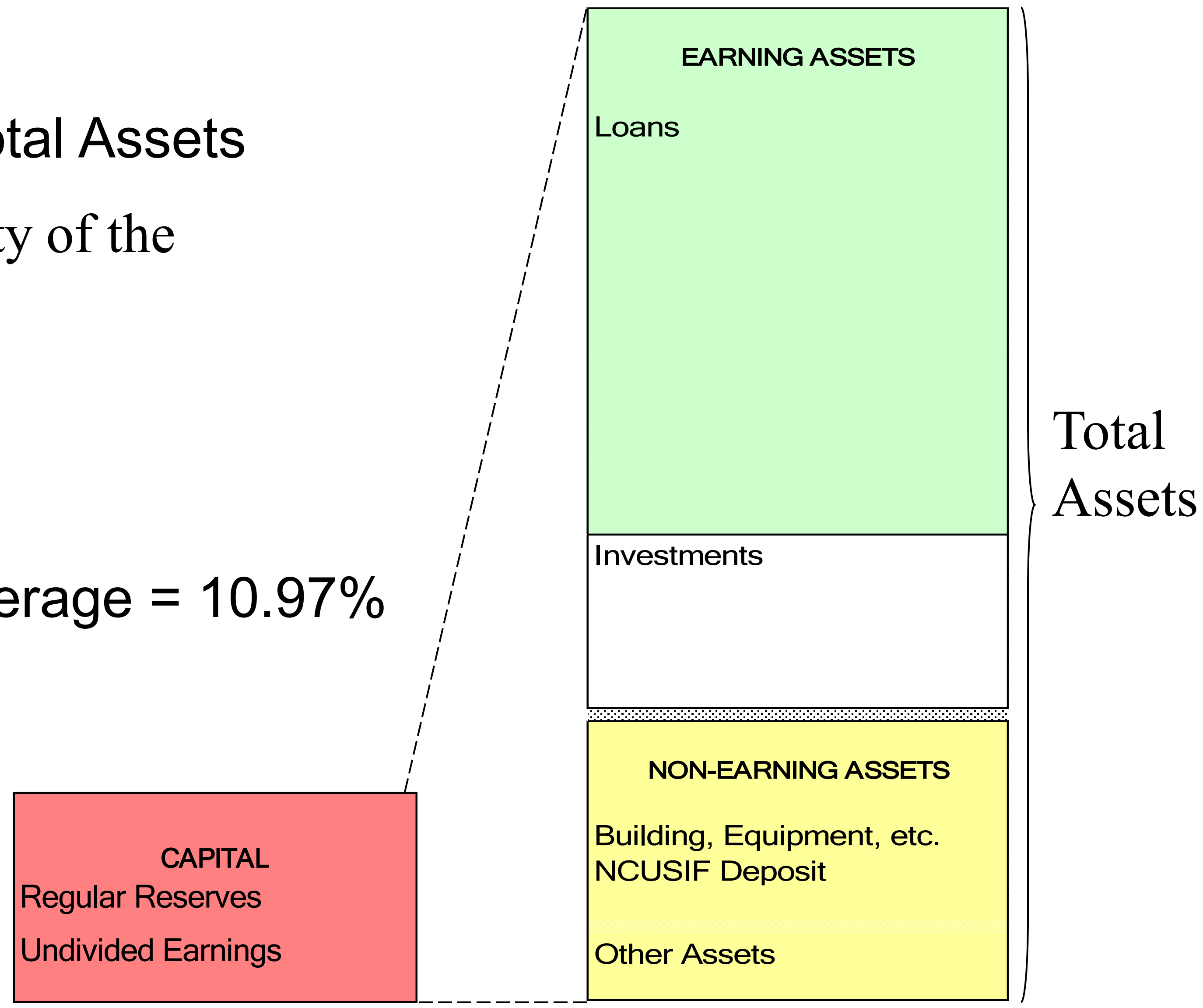
NET INCOME	$ 1,400

Capital To Assets Ratio

Total Capital/Total Assets

Measures stability of the credit union

National Average = 10.97%

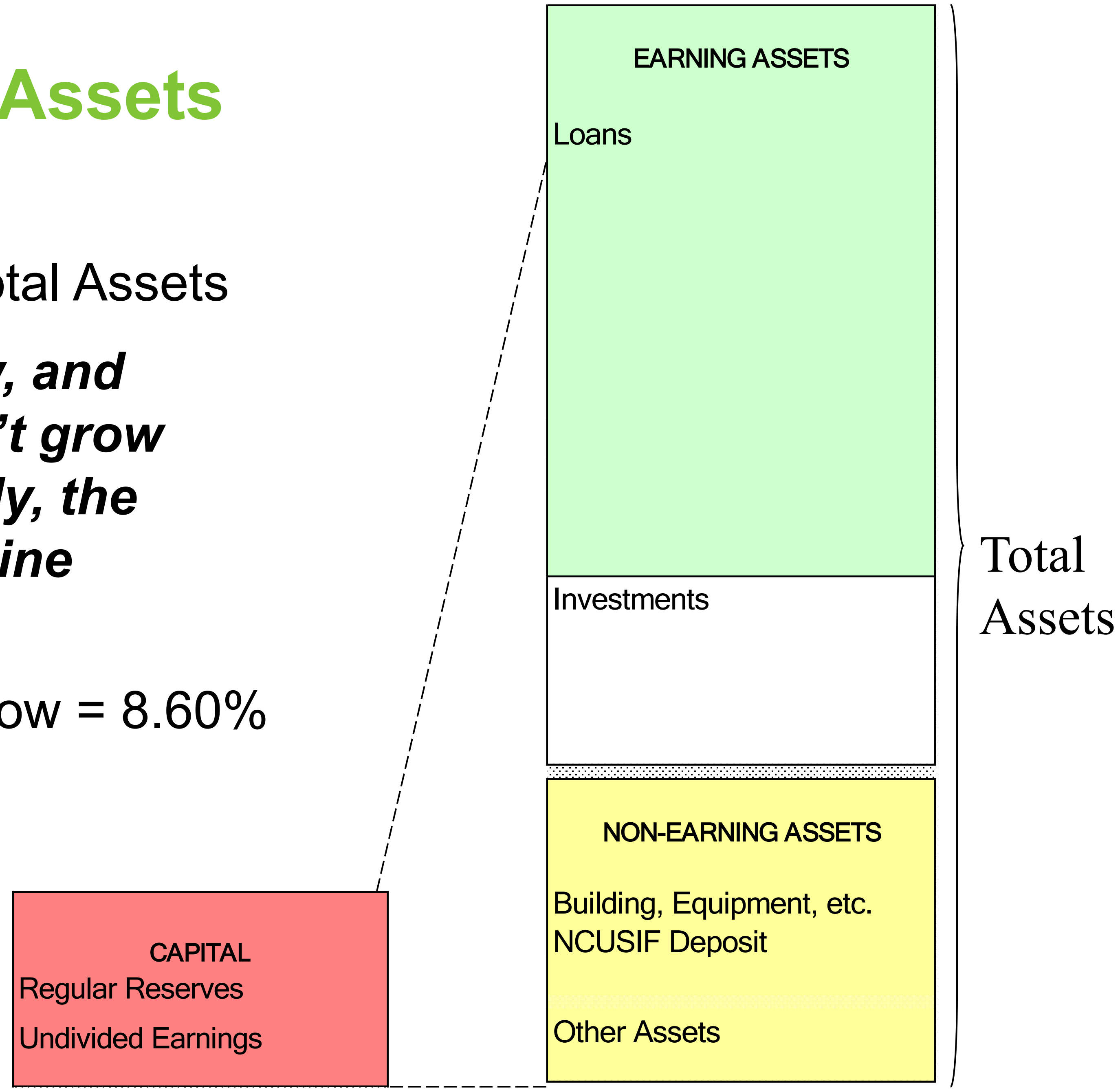


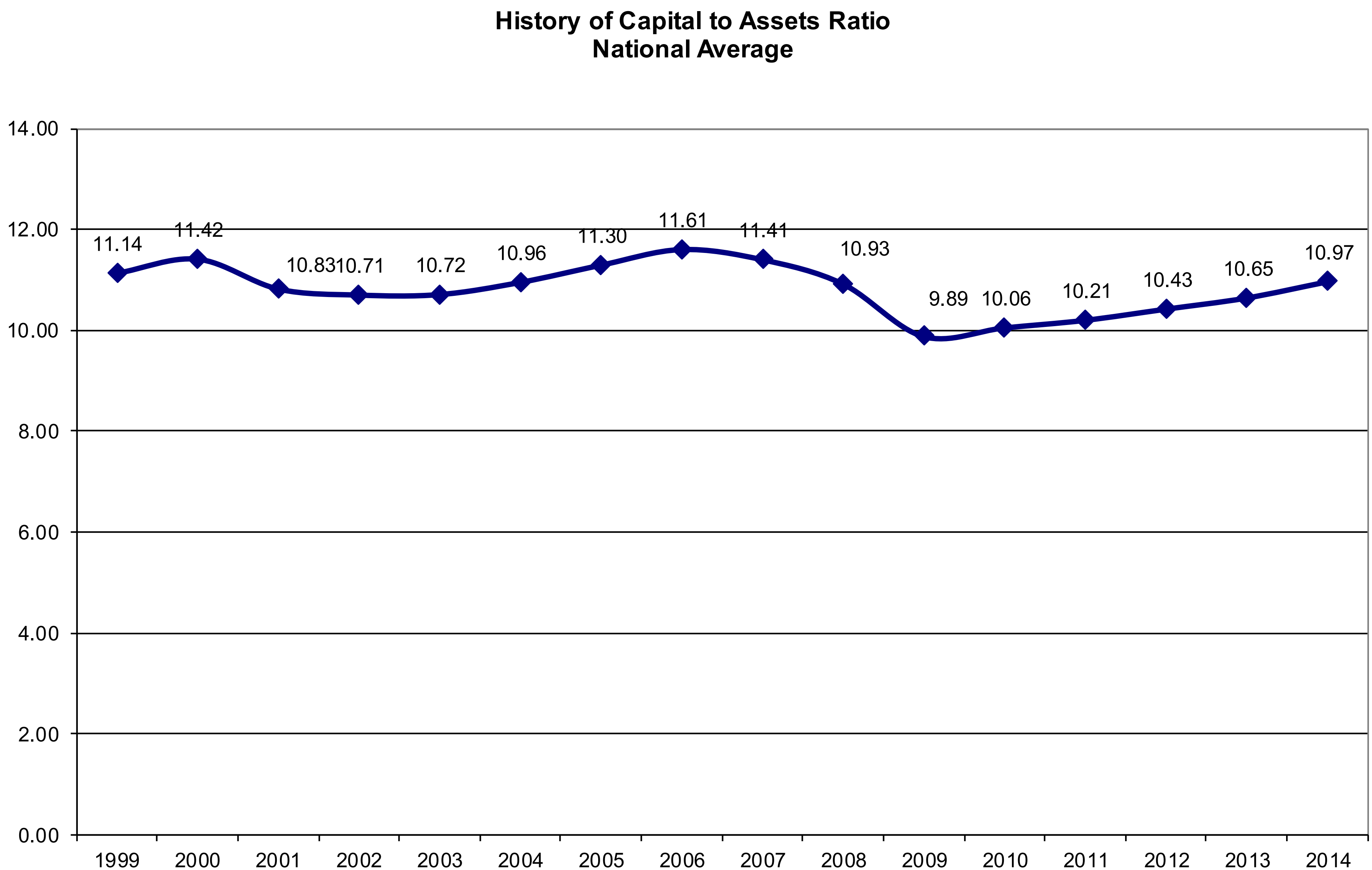
Capital To Assets Ratio

Total Capital/Total Assets

If Assets grow, and Capital doesn't grow proportionately, the Ratio will decline

Woops! Now = 8.60%




History of Capital to Assets Ratio
National Average
14.00
12.00
10.00
8.00
6.00
4.00
2.00
0.00
11.14
11.42
10.83
10.71
10.72
10.96
11.30
11.61
11.41
10.93
9.89
10.06
10.21
10.43
10.65
10.97
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014

NCUA Calculation a bit different

NET WORTH / TOTAL ASSETS

(Regular Reserve + Appropriation for Non-Conforming Investments [*SCU Only*] +Other Reserves + Undivided Earnings + Uninsured Secondary Capital [*Low-Income Designated CU Only*] + Net Income or (Loss)) / Total Assets *

*Total assets means a credit union's total assets as measured by either the:

(i) average quarterly balance of the four most recent calendar quarters; or

(ii) average monthly balance over the three calendar months of the calendar quarter; or

(iii) average daily balance over the calendar quarter; or (iv) quarter-end call report balance for the calendar quarter.

How much Capital is enough?

Project worst 3 years possible

If at end, > 4%, you <u>may</u> have enough

Prompt Corrective Action Rules

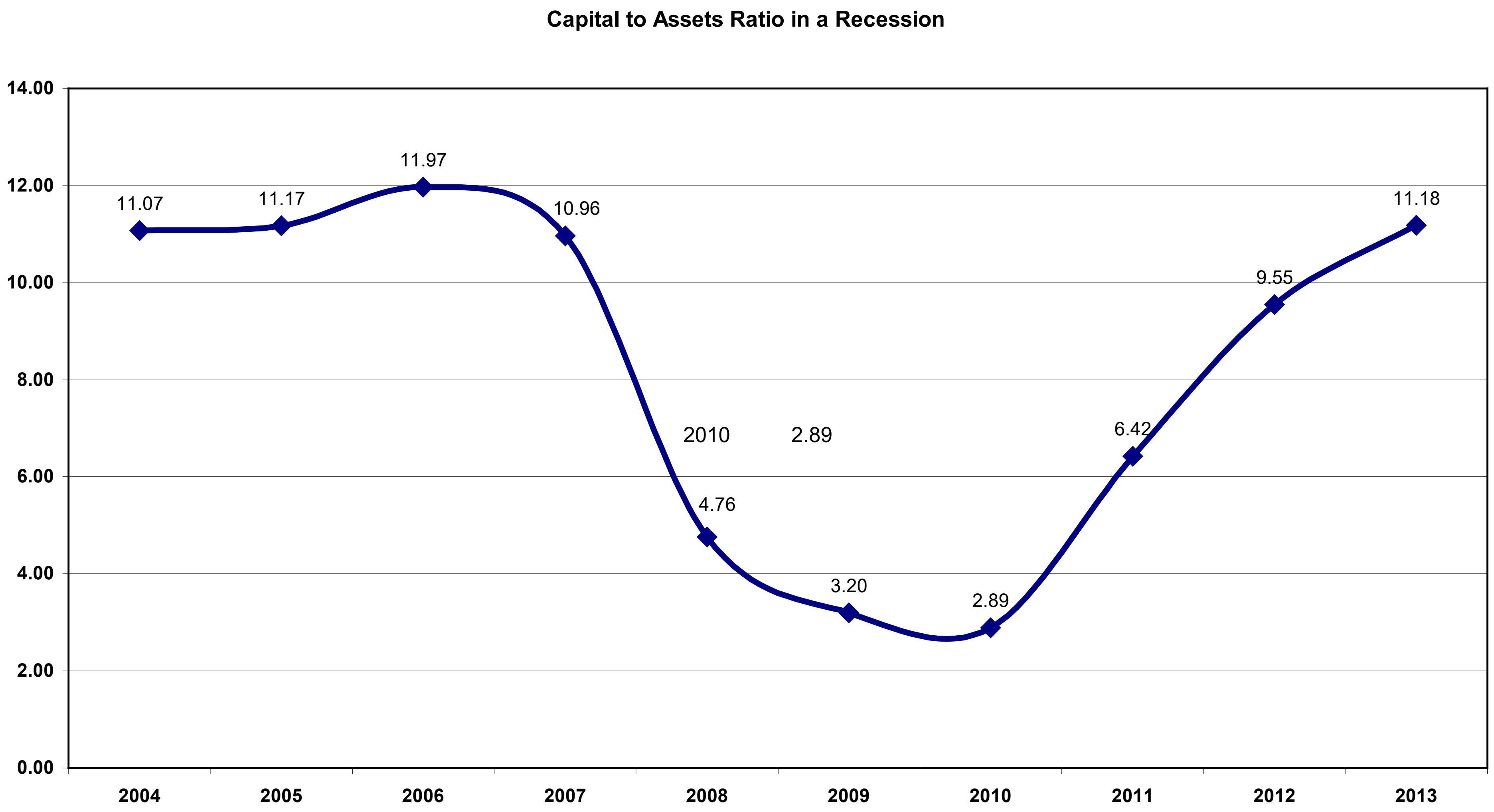
Depends on how much risk your assets and liabilities represent

Depends on level of growth

Depends on profitability of CU

Depends on future plans

Capital can disappear fast



Prompt Corrective Action

• 7% or higher	Well capitalized
• 6%-6.99%	Adequately capitalized
• 4%-5.99%	Undercapitalized
• 2%-3.99%	Significantly undercapitalized
• Less than 2%	Critically undercapitalized

Prompt Corrective Action

- **Mandatory Supervisory Actions**
  - Below 7% - transfer 0.1% of Total Assets to Regular Reserve each month
  - Below 6%
    - Develop a Net Worth Restoration plan
    - Limit asset growth
    - No new member business loans
- **Discretionary Supervisory Actions**

The lower you go, the more authority the regulators take away from management and the Board

Balance Sheet

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Cash	$ 160,000
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NET INCOME

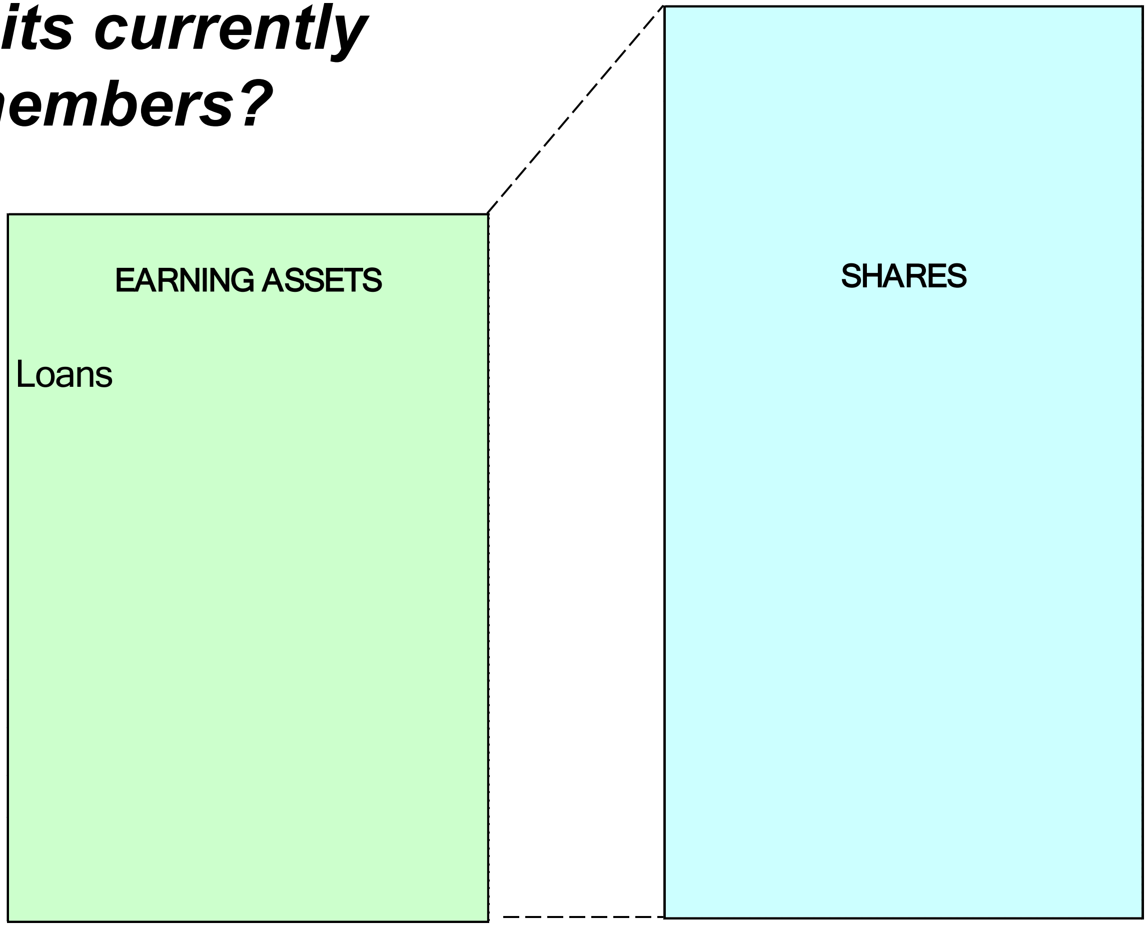
NET INCOME	$ 102,000

Loan to Share Ratio

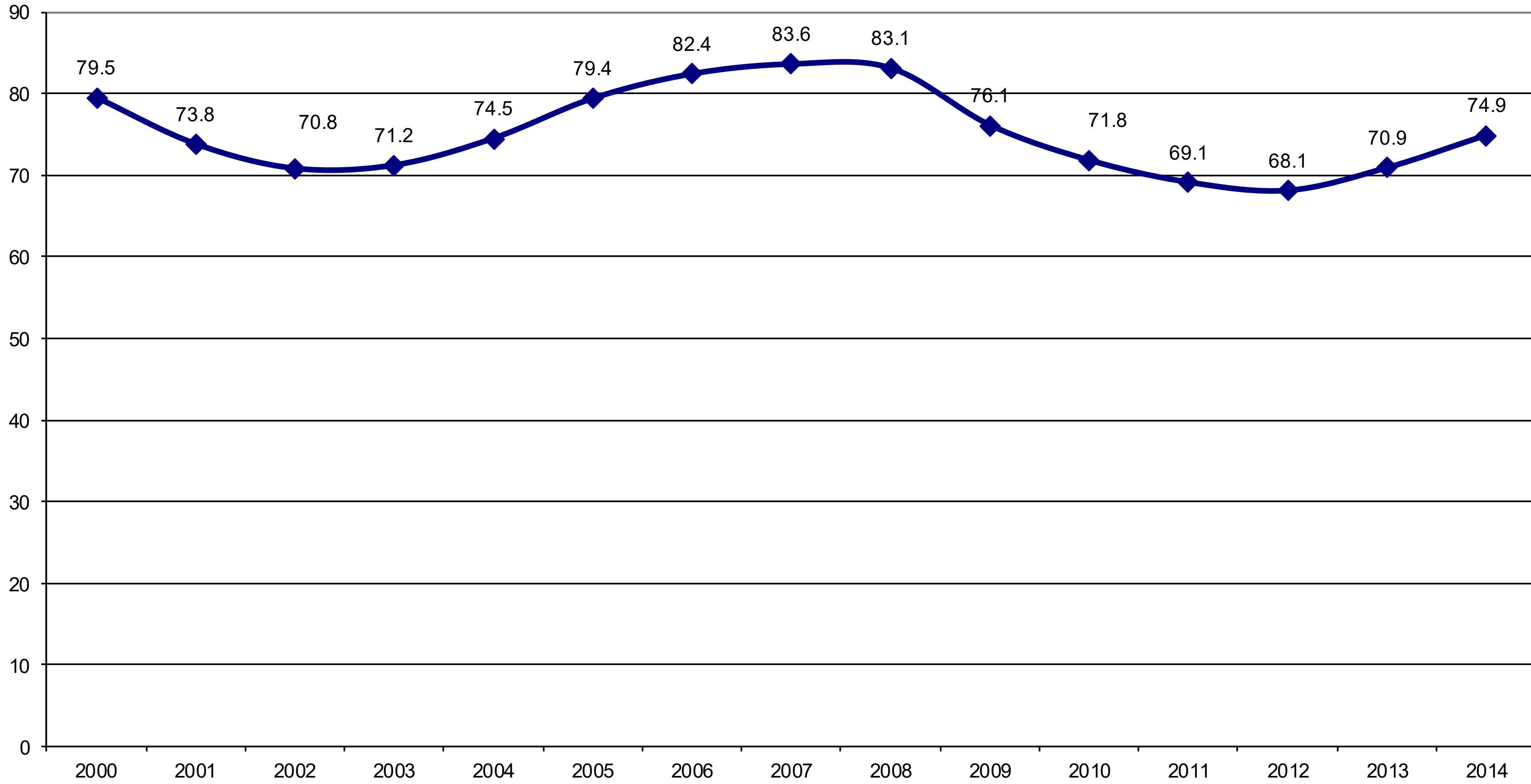
Total Loans / Total Shares and Deposits

% of our Deposits currently loaned out to members?

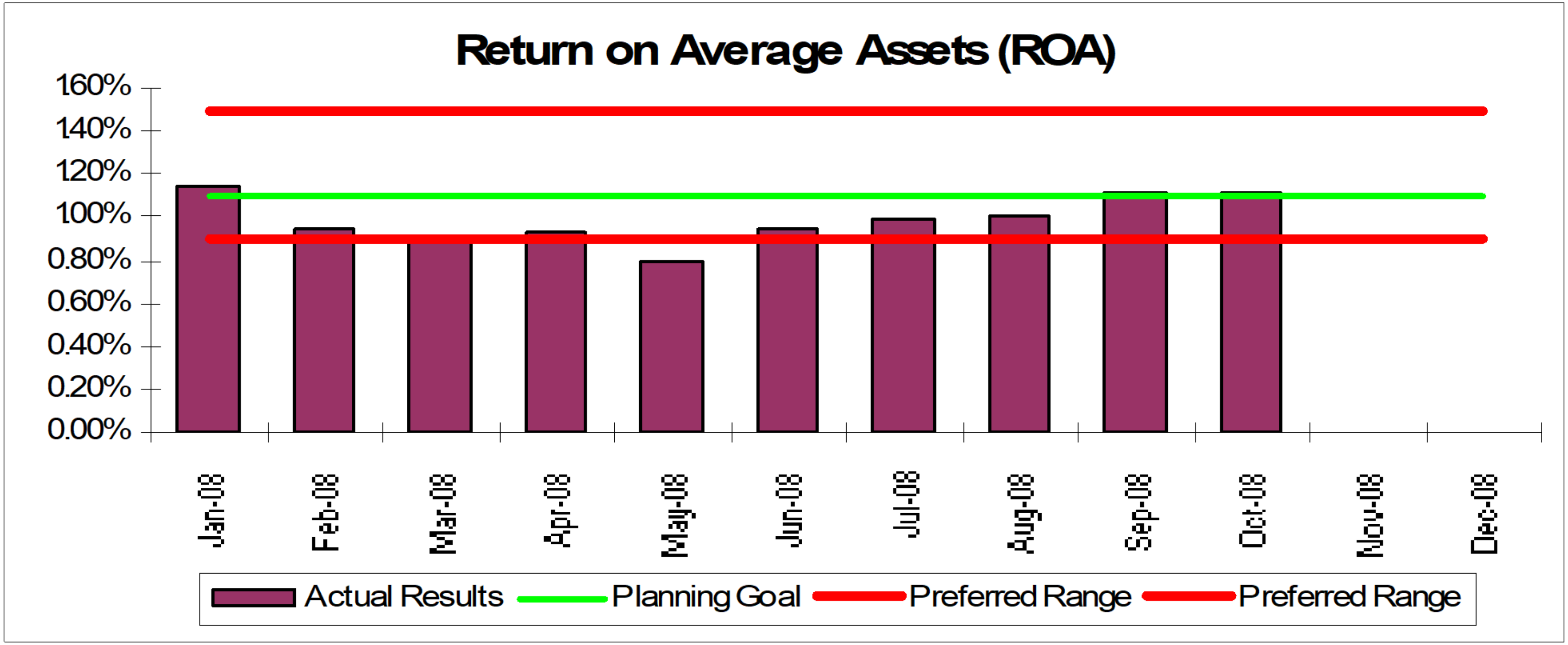
National Average = 74.9%



History of Loan to Share Ratio
National Average



Using a Dash Board



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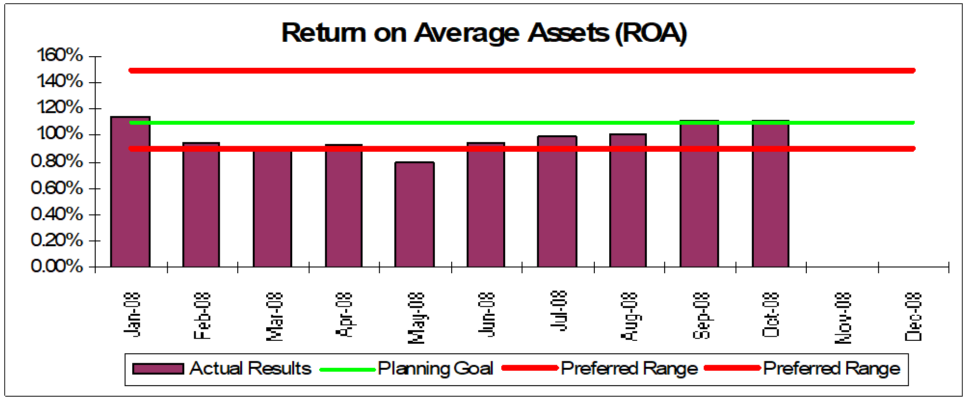
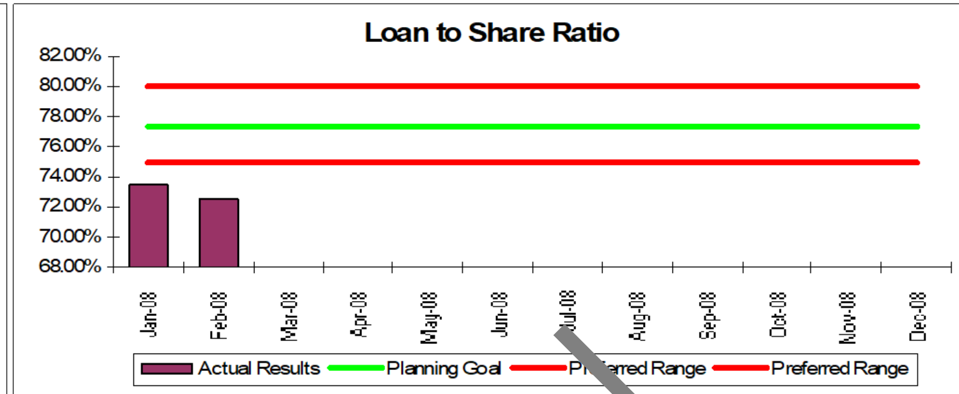

Return on Average Assets (ROA)
160%
140%
120%
100%
0.80%
0.60%
0.40%
0.20%
0.00%
Jan-08 Feb-08 Mar-08 Apr-08 May-08 Jun-08 Jul-08 Aug-08 Sep-08 Oct-08 Nov-08 Dec-08
Actual Results
Planning Goal
Preferred Range
Preferred Range


Loan to Share Ratio
82.00%
80.00%
78.00%
76.00%
74.00%
72.00%
70.00%
68.00%
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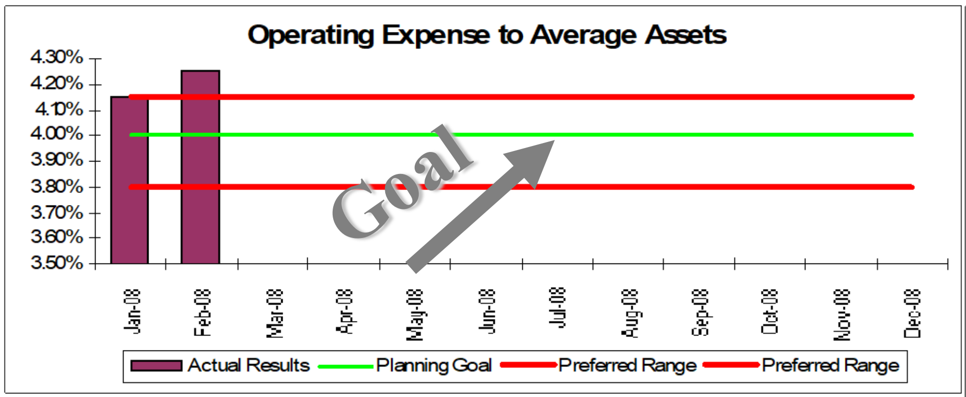
Operating Expense to Average Assets
4.30%
4.20%
4.10%
4.00%
3.90%
3.80%
3.70%
3.60%
3.50%
Goal
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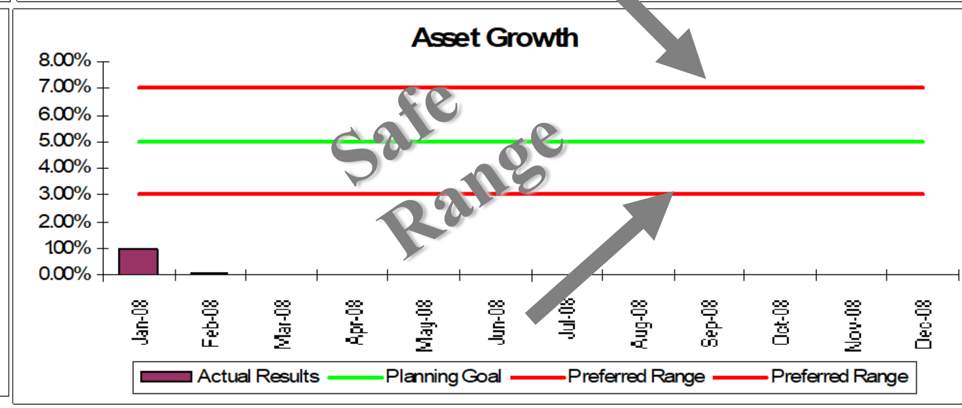
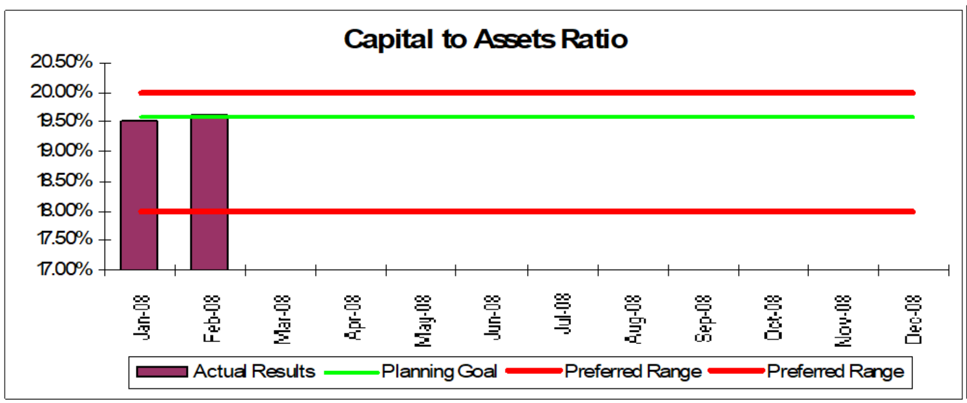
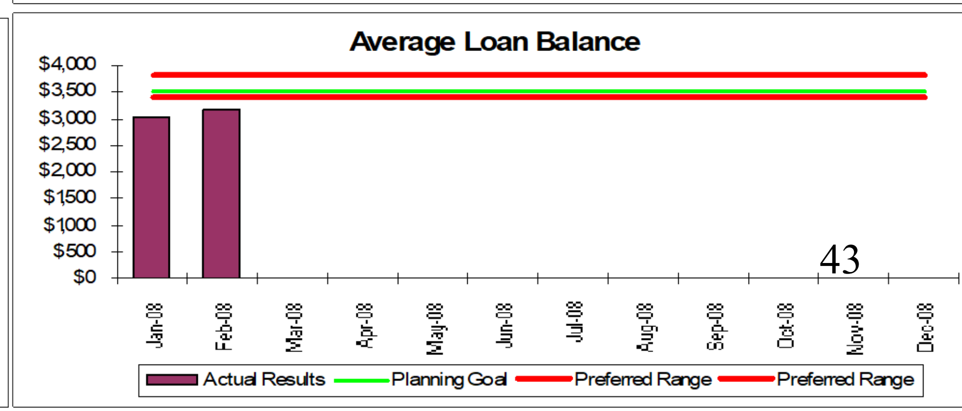

Asset Growth
8.00%
7.00%
6.00%
5.00%
4.00%
3.00%
2.00%
100%
0.00%
Safe
Range
Jan-08 Feb-08 Mar-08 Apr-08 May-08 Jun-08 Jul-08 Aug-08 Sep-08 Oct-08 Nov-08 Dec-08
Actual Results
Planning Goal
Preferred Range
Preferred Range


Capital to Assets Ratio
20.50%
20.00%
19.50%
19.00%
18.50%
18.00%
17.50%
17.00%
Jan-08 Feb-08 Mar-08 Apr-08 May-08 Jun-08 Jul-08 Aug-08 Sep-08 Oct-08 Nov-08 Dec-08
Actual Results
Planning Goal
Preferred Range
Preferred Range


Average Loan Balance
$4,000
$3,500
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$0
Jan-08 Feb-08 Mar-08 Apr-08 May-08 Jun-08 Jul-08 Aug-08 Sep-08 Oct-08 Nov-08 Dec-08
Actual Results
Planning Goal
Preferred Range
Preferred Range

TIM Touch Inspire Motivate

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