

# Financial Literacy

Central Minnesota Chapter  
of Credit Unions  
St. Cloud, Minnesota  
May 12, 2011



# Speaker's Biography – Rich Gabrielson

- Rich Gabrielson, CPA, is a principal with LarsonAllen and supervises audit and related services to many of the firm's credit union clients. Rich has developed an excellent working relationship with the NCUA and the individual state regulatory departments in multiple states.
- Committed to the advancement of the credit union movement, he is a frequent speaker and workshop presenter for credit union chapters and trade association groups, conducting numerous roundtable discussions and supervisory committee workshops. In recent years he has presented workshops on Auditing Business Lending at both the AICPA and ACUIA national conferences and in the fall of 2008 presented on Current ALL Issues at the AICPA National Credit Union Conference.
- Rich has significant business lending background from both the financial institution and borrower perspective. His experience with commercial clients has been extremely beneficial over the past 20 years in our work with credit union business lending portfolios. Rich served for four years on AICPA's Credit Union Committee and is an ongoing participant on the Regulatory Task Force.



# Agenda

- Understanding the Regulation Change (5 minutes)
- Understanding Financial Reports (25 minutes)
- Understanding Key Ratios (5 minutes)
- Understanding Budgeting (5 minutes)
- Reviewing the answers to the Pre-test (5 minutes)
- Wrap-up and Questions (5 minutes)



# Why are we here?

Learning objective – to make you a better Board Member

Each of you have a been provided a Pre-test

By the completion of the session we will have covered these items and more



# Part 1 –



## Understanding the New Regulation

Learning Objective – to better understand what has changed and why it is important

# Why are we here?

## NCUA Regulation 701.4

### General Authorities and Duties of Federal Credit Union Directors

(Currently not a statutory requirement for Board members of MN state chartered credit unions but is a “best practices” recommendation)



# Duties of the Director

*The board of directors is responsible for the general direction and control of the affairs of a federal credit union. The board may delegate operational functions to management but not the responsibility for the credit union's direction. The board must directly exercise its authority to hire, fire, determine duties, set compensation, and discipline senior management. The board must also ensure that appropriate policies are in place to guide senior management. (Excerpts from NCUA Letter to FCUs 11-FCU-02)*

## Per NCUA Regulation 701.4

- Director should carry out duties in good faith
- For the best interests of the membership as a whole
- With care, including reasonable inquiry
- As an ordinarily prudent person would use



# Duties of the Director

## Per NCUA Regulation 701.4-(Continued)

- Administer the CU affairs fairly and impartially, without discrimination
- Obtain, within 6 months, a working familiarity with basic finance and accounting practices to read and understand the CU's ***balance sheet and income statement*** and ask substantive questions of management and auditors
- Direct management's operations in conformity with the FCU Act, other appropriate laws and sound business principles



# Why the need for fiduciary prudence?

- Credit Unions operate in an environment filled with risks.

*(Risk is the potential that an event, expected or unanticipated, may have an adverse effect on the credit union's net worth and earnings, and accordingly the safety and soundness of member deposits and the insurance fund. )*

- The categories of risks for credit union purposes are:

- ◇ *Credit*
- ◇ *Interest Rate*
- ◇ *Liquidity*
- ◇ *Transaction*
- ◇ *Compliance*
- ◇ *Strategic*
- ◇ *Reputation*

- Any product or service may expose the credit union to **multiple risks; these categories are not mutually exclusive.**



# Risks are Identified and Managed in Policies

- Policies reflect the board's intent and commitment in pursuing desired results. Effective management requires written policies the credit union adheres to in practice.
- Policies set standards and courses of action to pursue, implement, and enforce specific objectives. Good policies link with, and reflect, a credit union's underlying mission, values and principles. They also clarify the credit union's tolerance for risk.
- Credit Unions should have mechanisms in place to trigger a review of policies in the event activities or tolerances change.



## Processes Pursue Objectives while Controlling Risk

- Processes include procedures, programs, and practices governing how a credit union pursues objectives, and define how it carries out daily activities.
- Good processes demonstrate consistency with the underlying policies, efficiency, and adequacy of internal control checks and balances.



# Personnel Execute the Policies and Processes

- Personnel encompass the staff and managers executing or overseeing performance of the processes.
- Qualified, competent managers and staff should perform as a conscientious board expects. They must understand the mission, values, policies, and processes.



# Control Systems-Manage and Monitor Risks

- Control systems are tools and information systems managers use to measure performance, assist in decision making, and assess the effectiveness of existing processes.
- Sound control systems require timely, accurate, and informative feedback devices.
- Management must implement reporting systems by which they communicate necessary and sufficient information to the directors.



## Part 2 –



# Understanding Financial Reports

Learning Objective – to better understand the common financial reports in the credit union industry

# The Financial Process and Statements

- The Accounting Process
- Key Financial Statements
- 5300 Regulatory Report (Call Report)
- The CAMEL Rating System



# Introduction

Financial statements are an important management tool. When correctly prepared and properly interpreted they contribute to an understanding of the current financial condition, problems, and opportunities of a credit union.



# NCUA 701.4 and Financial Statements

- Understanding The Accounting Equation and Double Entry Accounting
- Reading and Understanding Financial Statements -
  - Balance Sheet / Statement of Financial Condition
  - Income Statement
- Responsible inquiries ? What does that mean?



# The Business of a Credit Union

- CU's are different from many other businesses as they don't sell product or carry inventory.
- As a result their financial statements (Balance sheet and Income statement) are different.
- They primarily are a depository for member funds and intend to make a small amount of money on every dollar they handle.
- It all starts with members making deposits. This creates cash on hand which can either be lent out, invested, or used for liquidity (withdrawals).



# Sources of CU Revenue

- Interest income on loans
- Interest income on excess funds not loaned out
- Fees charged for services
- Interchange income from credit and debit card products
- Miscellaneous income



# CU Expenses

- Dividends or interest paid on member deposits
- Interest paid on any borrowings
- Loan losses on lending to members
- Salaries and benefits to employees
- Occupancy costs for facilities
- Information processing costs
- Other operating expenses



# Accounting

- The Credit Union's Accounting System is the Basis to Capture Transaction Data and Turn it Into Measured Results.

## The Accounting System

Vouchers (*Cash Rec. / Disb, Checks, Journal Voucher, EFT's*)

Settlements (*Teller, Back office, ACH, Loans, Drafts, ATM etc.*)

Daily Proof (*Summary Audit Transaction List*)

General Ledger (*Chart of Accounts, Recording Transactions*)

Subsidiary Ledgers (*Share/Loan, Investments, Fixed Assets etc.*)

Trial Balance (*General ledger Proof for Balancing*)

Financial Statements (*Balance Sheet, Income Statement*)

Statistical Reports (*Delinquency, Trends, Historical, Peer Data*)



# Accounting

- Accounting By Nature Must Follow Certain Definite Rules.

## Accounting Fundamentals

Double Entry – Debits / Credits

Historical Basis

Fair Value

Conservatism

Consistency

Generally Accepted Accounting Principles

Estimate Policy

Full and Comprehensive Disclosure

Internal Controls

Assertions



# Accounting Equation

- The Accounting Equation for Credit Unions is the Same for all Other Businesses
- In Double Entry Accounting: Debits must = Credits For Every Transaction, Every Entry, Every Financial Event!
- **Assets = Debits** (Loans, Cash, Investments)
- **Liabilities = Credits** (Shares, Payables, Accrued Expenses)
- **Equity = Credits** (Undivided Earnings, Reserves)
- **Income = Credits** (Interest on Loans Investments, Fees)
- **Expenses = Debits** (Salaries, Dividends, Operating Costs)

THE ACCOUNTING EQUATION

**ASSETS = LIABILITIES + EQUITY**



# Accounting Equation - Continued

- The Expanded Accounting Equation:

= GENERAL LEDGER

ASSETS = LIABILITIES + EQUITY + (INCOME + EXPENSE)

= Balance Sheet

= Income Statement

Still Picture

AS OF DATE

Historical Balances

What You Own, Owe, and Have Earned

Moving Picture

PERIOD IN TIME

Temporary Totals

Net Cumulative Totals



# Financial Statements – Balance Sheet

In order to be able to understand and interpret the data in the financial statements, we must understand the classification of items appearing on each statement. Let's examine each statement carefully:

## BALANCE SHEET

Its name implies a lot about the basics of this financial statement – “Balance” In this statement,  $\text{Assets} = \text{Liabilities} + \text{Equity}$ .

**Assets** are grouped and presented together (these are items the CU owns such as cash, loans, investments, and equipment. Total Assets are Summed.

**Liabilities** are grouped and presented together (these are things the CU owes such as member shares, payables. Total Liabilities are Summed.

**Equity** is the accumulated net income or loss since the day the CU opened till now, each member owns a pro-rata portion. Equity is Summed.



# Financial Statement – Balance Sheet

## A Typical Balance Sheet

### ASSETS

CASH  
MEMBER LOANS  
(ALLOWNCE FOR LOAN LOSS)  
INVESTMENTS  
ACCRUED INCOME  
FIXED ASSETS, EQUIPMENT  
PREPAID EXPENSES  
OTHER RECEIVABLES  
OTHER ASSETS

### TOTAL ASSETS

### LIABILITIES

MEMBERS' SHARE DEPOSITS  
ACCOUNTS PAYABLE  
DIVIDEND PAYABLES  
ACCRUED EXPENSES

### TOTAL LIABILITIES

### MEMBERS EQUITY

UNDIVIDED EARNINGS  
REGULAR RESERVE  
NET INCOME (PRECLOSE)

### TOTAL LIABILITIES AND MEMBERS EQUITY



# Financial Statement – Income Statement

The Income Statement contains no Assets, Liabilities or Equity accounts, only Income and Expense accounts. Income and Expenses are accumulated for a period of time, (Monthly, Quarterly, Annually) and netted to a Net Income total if Income exceeds Expenses, OR a Net (Loss) if Expenses exceed Income for the period. Net Income/(Loss) is closed to Equity at the end of the accounting period to the Undivided Earnings account.

## Income

Interest on Loans  
Interest on Investments  
Fees and Charges  
Other Operating Income  
Non Operating Gain/Loss

## Expenses

Dividends  
Salary and Benefits  
Operations  
Provision for Loan Losses  
Insurance Expense



# Financial Statement – Income Statement

## A Typical Income Statement

### INCOME

INTEREST INCOME

LESS INTEREST EXPENSE

NET INTEREST INCOME

PROVISION EXPENSE

NET INTEREST INCOME AFTER PROVISION

OTHER INCOME

OPERATING INCOME BEFORE EXPENSES

### EXPENSES

COMPENSATION AND BENEFITS

OCCUPANCY EXPENSE

OFFICE OPERATIONS

PROFESSIONAL OUTSIDE SERVICES

INSURANCE

OTHER OPERATING EXPENSE

TOTAL EXPENSES

NET INCOME/(LOSS)



# Financial Statements – The Link

## The Link

The balance sheet and the income statement do not share accounts from the credit union's accounting system, however there is a link that is vital to the accounting equation and the accounting system. The link is net income/(loss) is "closed" to equity (the Undivided Earnings Account) at the end of each accounting "period". The accounting period will vary from credit union to credit union, but is typically either monthly or quarterly.

You will find ***net income or (loss)*** on the balance sheet under the equity section during interim accounting periods.



# Financial Statements and Reports

## Other Financial Statements:

Statement of Changes in  
Members' Equity

Cash Flow Statement

Comparative Financial Statements

## Other Financial Reports:

Delinquent Loan Report

New Loan Report

Investment Report

Statistical Report

Transaction Activity Reports

New Closed Accounts Reports

Cash Liquidity Report

Share by Type Report

Loan by Type Report



# Understanding Financial Statements

Understanding a financial statement requires a basic understanding of relationships between accounts and balances in the statement.

## Beginning Questions:

- What are the financial statement basics?
- What are the most important things to look for in Credit Union financial statements?
- Am I looking for different things from a balance sheet than an income statement?
- What are financial statement trends and how do I spot them?
- What accounts inter-relate in CU financial statements?
- Are all CU balance sheets and income statements alike?
- How do I know if my CU is improving or declining?



# Understanding Financial Statements

## Tips for Financial Statement Users:

- Request comparative financial statements, reviewing more than one financial statement period is always better as it gives the reader a reference point to compare results.
- Look for trends in key accounts, determine if these trends are positive or negative and if they are expected.
- Look for relationships between trends on the balance sheet and results on the income statement.
- Calculate variances in balances from period to period and understand why they occurred.
- Compare totals and statistics from one period to the next and determine if trends equal the change in statistical totals.



# Understanding Financial Statements

## Balance Sheet Keys:

- Total Assets
- Earning Assets vs. Non-Earning Assets
- Yield on Earning Assets
- Maturity of Earning Assets (Liquidity)
- Relationship of Yield to Maturity
- Risk vs. Yield (Term and Collateral)
- Long term vs. Short term
- Cost of Funds (Dividends on Member Deposits)
- The Equity Link



# Understanding Financial Statements

## Income Statement Keys:

- Yield on Loans and Investments
- Yields Computed on Average Balances
- Comparative Results Between Periods YR to YR / Month to Month
- Trends in Performance
- Net Income
- Spot Significant Variances
- Unanticipated/ Unexpected Results Must be Explained.
- Budget vs. Actual, The Budget as a Tool
- Know Where Income and Expense Items Originate



# Understanding Financial Statements

## KEY FINANCIAL RELATIONSHIPS:

### ACCOUNT

- LOANS
- INVESTMENTS
- TOTAL ASSETS
- SHARES
- # OF EMPLOYEES
- EQUITY

### RELATIONSHIP

INT INCOME ON LOANS, PROVISION EXP  
INT INCOME ON INVESTMENTS  
FEE INCOME  
DIVIDEND EXPENSE  
COMPENSATION AND BENEFITS  
NET INCOME/ TOTAL ASSETS



# Understanding Financial Statements

## FINANCIAL BUZZ WORDS/PHRASES:

- Share to Loan Ratio =  $\text{Loans} / \text{Shares}$
- Cost of Funds = The Average Dividend Rate Paid on Member Accounts
- Charge-off Rate =  $\text{Net Charged-off Loans} / \text{Average Loans}$
- Delinquency Rate =  $\text{Delinquent Loans} / \text{Average Loans}$
- Depreciation = To Expense an Asset over its Useful Life
- Yield = The Rate Earned on an Asset over Time, Usually one Year
- Net Spread = The Difference on Earned Assets over Cost of Funds
- Trend = A result over Time either an Increase or Decrease in Performance
- Variance = Difference or Change in Comparative Totals



# Statement of Financial Cond. (cont.)

- **Loans held for sale** consist of mortgage loans originated and intended for sale in the secondary market. These loans are stated net of any anticipated losses.
- **Loans receivable** consist of the outstanding loans due to the credit union which usually generate the largest portion of a credit union's revenue and represent the most significant component of its assets. The loans are reduced by the amount of the allowance for loan losses.
- **Accrued interest receivable** is the interest income earned during the period but not yet collected.
- **Other real estate owned** includes real estate properties acquired through or in lieu of loan foreclosure.
- **Property and equipment** includes such items as land, buildings, furniture, fixtures, and equipment.
- **NCUSIF deposit** is the deposit in the National Credit Union Share Insurance Fund. Maintenance of a deposit of 1 percent of its insured shares is required by NCUA regulations.
- **Other assets** of a Credit Union frequently include such items as accounts receivable, prepaid expenses, and in-transit or suspense items.



# Statement of Financial Cond. (cont.)

- **Liabilities** are made up of legal obligations to repay debts or deposits.
  - **Members' share and savings accounts** are the principal source of funds for credit unions.
  - **Borrowed funds** is the money borrowed to meet the credit union's short-term operational needs. Examples include lines of credit drawn on mortgages payable, capital lease obligations, and notes payable.
  - **Accrued interest payable** is the interest that has become due during the period but has not yet been paid.
  - **Accrued expenses** are other payables which have been withheld or collected but not yet remitted. Examples include such items as payroll taxes withheld and miscellaneous expenses accrued on a monthly basis.
  - **Other liabilities** is the caption used for all liabilities not specifically listed elsewhere.



# Statement of Financial Cond. (cont.)

- **Members' equity** generally consists only of undivided earnings, statutory reserves, and other appropriations as designated by management or regulatory authorities. Credit unions are required by regulation to maintain a statutory reserve which is not available for the payment of interest or dividends.



# The Statement of Income in Greater Detail

- **Interest income** is the income earned on the various loans and investments of the credit union.
- **Interest expense** is dividends and interest the credit union paid out on members' share and savings accounts, certificates of deposit, and on any funds borrowed from other financial institutions.
- **Provision for loan losses** is the expense made in the current period to increase allowance for loan losses; established for loans which may become uncollectible.
- **Non-interest income** is income earned from any source other than interest.
  - **Gain on sales of interest-earning assets** is the interest earned on the sale of items such as mortgage-backed securities, investment securities, and loans receivable.
  - **Unrealized gains on trading account securities** is the gain due to the change in the market price of the securities. This gain cannot be realized until the securities are sold. If the market price of the securities falls below the original cost, then this figure would be a loss.
  - **Loan Servicing fees** are the fees collected from others for servicing their loans.
- **Non-interest expense** includes the expenses for anything other than interest.
  - **General and administrative** expenses are for such items as compensation, employee pension plan, and other benefits, operations, and occupancy.




# NCUA Form 5300 (the Call Report)

- Prepared quarterly
- Submitted electronically
- Contains some “GAAP” type statements
- Contains other supporting information
- Tested by the examiners periodically
- Taken very seriously by the NCUA in monitoring the industry
- Generates NCUA’s Financial Performance Report for the CU



# NCUA Form 5300 at www.ncua.gov

 **Credit Union ONLINE**

FIND A CREDIT UNION

General | Call Reports | Contacts | Sites | IS & T | Regulatory | CUSOs | Programs & Services

**RELATED TASKS**

- FIND A CREDIT UNION
- FINANCIAL PERFORMANCE REPORT
- CALL REPORTS

## VIEW GENERAL CREDIT UNION INFORMATION ?

CREDIT UNION INFORMATION	
<b>Charter Number:</b>	60646
<b>Credit Union Name:</b>	COAST LINE
<b>Credit Union Type:</b>	FISCU - Federally Insured
<b>Status:</b>	Active
<b>Corporate Credit Union:</b>	No
<b>Year Chartered:</b>	1927
<b>Date Insured:</b>	10/14/1971
<b>Region:</b>	Region I - Albany
<b>Charter State(State Credit Union Only):</b>	ME
<b>Field Of Membership Type:</b>	99 - Non-Federal Credit Union
<b>Low Income Designation:</b>	No
<b>Member of FHLB:</b>	Yes

**CONTACT INFORMATION**



# NCUA Form 5300 - Online

PAGES		
Title	Paper Page #	Actions
Statement of Financial Condition (This page must be completed by all credit unions.)	1	<a href="#">VIEW</a>
Statement of Financial Condition (continued) (This page must be completed by all credit unions.)	2	<a href="#">VIEW</a>
Statement of Financial Condition (continued) (This page must be completed by all credit unions.)	3	<a href="#">VIEW</a>
Statement of Financial Condition (continued) (This page must be completed by all credit unions.)	4	<a href="#">VIEW</a>
Income and Expense (This page must be completed by all credit unions.)	5	<a href="#">VIEW</a>
Miscellaneous Information (This page must be completed by all credit unions.)	6	<a href="#">VIEW</a>
Delinquent Loans by Collateral Type (This page must be completed by all credit unions.)	7	<a href="#">VIEW</a>
Additional Delinquency Information (Included in the delinquent loan info reported on Pg 7) (This page must be completed.)	8	<a href="#">VIEW</a>
Loan Charge Offs and Recoveries (This page must be completed by all credit unions)	9	<a href="#">VIEW</a>
Liquidity, Commitments and Sources (All credit unions must complete lines 1 - 9, if applicable).	10	<a href="#">VIEW</a>
PCA Net Worth Calculation Worksheet	11	<a href="#">VIEW</a>
Risk Based Net Worth Requirement (RBNW) - For credit unions with assets > \$10,000,000 and a RBNW requirement > 6%	12	<a href="#">VIEW</a>
Schedule A - Specialized Lending	13	<a href="#">VIEW</a>
Schedule A - Specialized Lending (continued)	14	<a href="#">VIEW</a>
Schedule A - Specialized Lending (continued)	15	<a href="#">VIEW</a>
Schedule B - Investments, Supplemental Information	16	<a href="#">VIEW</a>



# NCUA Form 5300

- Who at the credit union prepares?
- Who reviews ?
- Do we take any controversial positions?



# Uses of Financial Reports

- Used to measure financial results
- Used to measure productivity
- Used to measure progress toward goals
- Used to monitor risks
- Current “Best practices” is to make financial performance and measurement reports visual using graphs, trend lines, color coding (green-ahead or on track, yellow-borderline performance, red-behind goal)



# CAMEL Rating System

## CAMEL RATINGS FOR CU's

- # 1 – Indicates strong performance and risk management practices, historic trend and performance measures are consistently positive.
- # 2 – Reflects satisfactory performance and risk management practices, historic trend and performance measures are usually positive.
- # 3 – Indicates flawed performance and risk management is less than satisfactory, historical trend and performance measures are flat or negative, however CU is strong and viable, corrective action needed.
- # 4 – Refers to poor performance of a serious nature. Key measures are likely to be negative, CU may be threatened.
- # 5 – Unsatisfactory performance and critically deficient. Serious weaknesses and probability of failure.



# CAMEL Rating System

## NCUA CAMEL RATING SYSTEM

(NCUA Letter to Credit Unions: 07-CU-12)

NCUA adopted the CAMEL rating system in 1987.

- Purpose is to provide accurate and consistent measurements of a CU's performance and financial condition.
- CAMEL provides the CORE to NCUA examinations.
- C = CAPITAL
- A = ASSET QUALITY
- M = MANAGEMENT
- E = EARNINGS
- L = ASSET LIABILITY MANAGEMENT



# CAMEL Rating System

## CAPITAL – NET WORTH

NET WORTH = EQUITY / TOTAL ASSETS

PCA = PROMPT CORRECTIVE ACTION

7%	WELL CAPITALIZED;
6%	ADEQUATELY CAPITALIZED;
5%	UNDERCAPITALIZED;
4%	SIGNIFICANTLY UNDERCAPITALIZED;
3%	CRITICALLY UNDERCAPITALIZED

THREATS TO EQUITY – ALLL, GROWTH, EARNINGS, ALM, LIQUIDITY



# CAMEL Rating System

## ASSET QUALITY

- LOANS / DELINQUENT LOANS / CHARGE-OFFS
- INVESTMENTS
- ASSET MIX
- LIQUIDITY, MATURITY
- GROWTH TRENDS
- FAIR VALUE vs. COST OR CARRYING VALUE
- CONCENTRATIONS OF LOANS / INVESTMENTS / CASH
- POLICIES



# CAMEL Rating System

## MANAGEMENT

- STRATEGIC PLAN
- ALM POLICY AND MODEL
- COMPLIANCE
- TECHNOLOGY AND INFORMATION SYSTEMS
- INTERNAL CONTROLS
- FRAUD ASSESSMENT PROGRAMS
- SUCCESSION PLANNING
- RISK ASSESSMENT MANAGEMENT



# CAMEL Rating System

## EARNINGS

- RETURN ON AVERAGE ASSETS (ROA)  
 $\text{EARNINGS} / \text{AVERAGE ASSETS}$
- NET INTEREST MARGIN  
 $\text{INTEREST INCOME} - \text{INTEREST EXPENSE} / \text{AVE ASSETS}$
- OPERATING EXPENSE RATIO  
 $\text{OPERATING EXPENSES} / \text{AVE ASSETS}$
- COST OF FUNDS  
 $\text{INTEREST EXPENSE} - \text{DIVIDENDS} / \text{AVE ASSETS}$

## LIQUIDITY AND ASSET/LIABILITY MANAGEMENT



## Part 3 –



# Understanding Key Ratios

Learning Objective – to better understand Key Ratios used in the credit union industry

# Key Ratios

- Liquidity
- Earnings
- Capital
- Asset Quality
- Growth
- Other (Texas ratio)



# Common Financial Ratios - Liquidity Ratios

Liquidity ratios measure the credit union's ability to meet current demands for funds.

## 1. Loans-to-Shares Ratio

$$\frac{\text{Total loans outstanding}}{\text{Total shares and savings}}$$

This ratio measures the degree to which members' savings are funding loans to members. A high ratio can signal liquidity problems if the credit union faces high delinquency levels, heavy savings withdrawals, or high loan demand.

## 2. Loans-to-Asset Ratio

$$\frac{\text{Net loans to members}}{\text{Assets}}$$

This ratio shows the degree to which the credit union is providing its most important service - loans. A high ratio indicates less liquidity while a low ratio represents more.

## 3. Long-Term Assets to Total Assets

$$\frac{\text{Long-Term Assets}}{\text{Total Assets}}$$

Long-term assets include real estate and other loans with extended maturities, fixed assets, and long-term investments. A higher ratio of long-term assets to total assets is an indicator of less liquidity.



# Common Financial Ratios - Earnings Ratios

Earnings are the primary performance gauge for a credit union. Spread analysis is the main method of measuring earnings. The object of spread analysis is to determine the credit union's net spread for a time period. Net spread is the difference between what is earned on loans and investments and what is paid for funds after expenses have been covered.

## 1. Spread Analysis

### A. Yield on Assets

$$\frac{\text{Interest income}}{\text{Average total assets}}$$

The average total assets are calculated by adding the total assets at the beginning of the time period to total assets at the end of the time period and dividing the sum by two.

### B. Cost of Funds

$$\frac{\text{Dividend \& Interest expense}}{\text{Average total assets}}$$

### C. Margin or Spread

$$\text{Yield on assets} - \text{Cost of funds (A-B)}$$

### D. Provision for Loan Losses

$$\frac{\text{Provision}}{\text{Average total assets}}$$

### E. Net Operating Costs

$$\frac{\text{Operating costs} - \text{Non-interest income}}{\text{Average total assets}}$$

### F. Net Income

$$\text{Margin} - \text{Net operating costs and loan loss provision [C-(D+E)]}$$



# Common Financial Ratios

## Earnings Ratios (cont.)

### 2. Rate of Return on Loans to Members

$$\frac{\text{Total loan interest received during period}}{\text{Average loans outstanding}}$$

Since credit unions earn most of their income from loans it is critical to know the return on loans. If the percentage is less than the credit union's nominal lending rate, it is likely that there has been a significant change in market rates, that there is substantial loan delinquency, or that interest is not being calculated accurately. Average loans outstanding are calculated by taking the amount of loans outstanding at the beginning of the time period, adding them to the total for the end of the period, and dividing by two.

### 3. Operating Expense-to Assets Ratio

$$\frac{\text{Total operating expense}}{\text{Average assets}}$$

This ratio gives some indication of the organization's efficiency. As the credit union grows, this ratio should decrease. If the ratio does not meet the budgeted goals, it's likely that expenses were excessive.



# Common Financial Ratios - Capital Adequacy Ratios

Capital adequacy ratios are used to evaluate the credit union's capital position and ability to withstand potential losses.

## 1. Gross Capital Ratio

$$\frac{\text{Statutory reserves} + \text{other capital reserves (including allowance for loan losses)} + \text{Undivided earnings}}{\text{Total assets}}$$

This ratio shows total capital strength relative to total assets. It indicates the amount of financial cushion available to meet unexpected losses, fund new services, or finance fixed assets.

## 2. Net Worth Ratio

$$\frac{\text{Reserves (excluding allowance for loan or investment losses)} + \text{undivided earnings}}{\text{Total assets}}$$

This ratio indicates the amount of financial cushion available to the credit union to meet unexpected losses and fund new sources.

## 3. Delinquent Loans to Capital Ratio

$$\frac{\text{Delinquent loans}}{\text{Members' equity}}$$

This ratio measures the relationship of delinquent loans to capital. A small or declining ratio is a positive indicator.



# Common Financial Ratios - Asset Quality Ratios

For many credit unions, loans to members are the main asset, and loan delinquency is the gravest danger credit unions face. For this reason, determining the strength or quality of assets is a critical financial measurement. By calculating asset quality ratios, a credit union can determine the amount of risk it faces.

## 1. Delinquency Ratio

$$\frac{\text{Total delinquent loans}}{\text{Total loans outstanding}}$$

This shows the proportion of total loans outstanding that are delinquent and may become losses. The delinquency ratio is a key indicator of financial health of the credit union, as well as a predictor of loan repayment.

## 2. Loan Write-off Ratio

$$\frac{\text{Loan write-offs net of recoveries}}{\text{Average loans outstanding}}$$

A high ratio in this area may reflect a troubled economy or it could mean poor lending and/or collection practices.



# Common Financial Ratios - Growth Ratios

Growth ratios measure changes in savings, loans, net income, expenses, assets, liabilities, equity, membership or other indicators. These ratios help determine whether the credit union is growing as planned. These ratios also indicate if growth is adequate in comparison to membership potential.

## 1. Annual Membership Growth Ratio

$$\frac{\text{Current year membership} - \text{previous year membership}}{\text{Previous year membership}}$$

This ratio measures the credit union's growth from the previous year.

## 2. Annual Savings Growth Ratio

$$\frac{\text{Current year shares and savings} - \text{Previous year shares and savings}}{\text{Previous year shares and savings}}$$

This is the growth in shares and savings during the past 12 months. Annual growth rates in assets, loans, investments, equity, expenses, and net income can all be calculated using a method similar to that for annual member or deposit growth.



## Part 4 –



# Understanding Budgeting

Learning Objective – to better understand how a budget is created and used in the credit union industry

# Budgeting

- Definition – The projected results of planned activities intended to achieve the credit union's goals
- Developed by Management
- Approved by the Board of Directors
- Used to measure and monitor the CU's progress, much like a compass.



# Budgeting

- 1% ROA - Old Goal
- .35 to .65% ROA, Controlled growth, Concentration diversification, Fee income contribution, – Current Goals



# Budgeting – Goals Today

- Much lower ROA – not necessarily the optimum goal
- Capital Restoration
- Smaller credit unions – growth to a critical mass
- Recover impaired assets
- Survival

Know the Goals



# Budgeting – Zero Based Method

- All departments start with a beginning budget of \$0 and must build a case for all expenditures
- Good at eliminating waste
- Time consuming



# Budgeting – Incremental Method

- All departments begin with last years actual and adjust up or down based on expected activity
- Does not identify waste
- Fast



# Budgeting-Using Simulation Software

Permits quick evaluation of key assumption changes

- Begins with base period data
- Market interest rates changes and CU leading or lagging
- Product changes
- Marketing changes
- Staffing changes
- Facility changes
- Inter-relation of loans and deposits and income and expense



# Budgeting – Board Responsibility

- The primary responsibility of the board is to approve a budget that will achieve the organization's goals and strategic plan while understanding the risks assumed in that budget



# Budgeting – Does the Budget...

- Plan increases in higher risk loans?
- Plan increases in higher risk investments?
- Plan expansion into new member groups?
- Plan expansion into new geographies?
- Plan streamlining the loan origination process?

**We are taking on additional Credit Risk**



# Budgeting – Does the Budget...

- Anticipate an overly optimistic rate environment?
- Anticipate overly optimistic loan and deposit growth?

**We are taking on additional Interest Rate Risk**



# Budgeting – Does the Budget...

- Anticipate the ability to always obtain cheap borrowings?
- Anticipate the ability to always sell investments near par?
- Anticipate the ability to always originate high-rate loans?

**We are taking on additional Liquidity Risk**



# Budgeting – Does the Budget...

- Reduce internal audit resources?
- Reduce external audit resources?
- Reduce personnel resources to the point that control activities are reduced?
- Reduce insurance coverage?
- Not emphasize internal controls?

**We are taking on additional Transaction Risk**



# Budgeting – Does the Budget...

- Not address the current business environment?
- Rely on old business models that do not work?
- Not consider new business models that may be the future?
- Not consider the infrastructure needed to achieve goals?
- Not consider the personnel resources needed to achieve goals?

**We are taking on additional Strategic Risk**



# Budget – Does the Budget...

- Reduce controls over member data?
- Reduce resources devoted to safety and security?
- Reduce expenditures for new technology?
- Reduce expenditures over security training?

**We are taking on additional Reputation Risk**



# Thank You



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