



# Understanding Credit Union Financials for Beginner Auditors

Presented By:

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# Overview

# Learning Objectives

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- Familiarity with internal audit responsibilities
- Understanding key elements of the financial statements
- Calculate and interpret key financial ratios
- Analytical review to develop *good questions* about financial performance
- Highlights of NCUA Call Report & Financial Performance Reports (FPRs)





# Familiarity with Internal Audit Responsibilities

# Internal Audit Responsibilities

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- Internal audit: audits controls, are they operating effectively?
- Internal controls: preventative or detective (mitigating)

# Internal Audit Responsibilities

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- Provides independent assurances:
  - Risk management
  - Governance
  - Internal control processes
- Operating effectively

# Internal Audit Responsibilities

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- How is this accomplished?
  - Exam financial statements
  - Expense reports
  - Financial data
  - Accounting practices
  - Risk assessments

# Polling Question #1

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- What types of internal controls are there?
  - a) Preventative
  - b) Detective
  - c) Combative
  - d) Both a and b





# Understanding the Financial Statements

# Rewards Federal Credit Union Statement of Financial Condition

<b>Assets:</b>	<b>As of December 31, 2021</b>	<b>As of December 31, 2020</b>	<b>\$ Change</b>	<b>% Change</b>
Cash	\$ 2,625,000	\$ 1,650,000	\$ 975,000	59.09%
Investments	78,000,000	72,000,000	6,000,000	8.33%
Loans to members, net (see note 1)	215,375,000	200,350,000	15,025,000	7.50%
Prepaid and other assets	1,000,000	1,500,000	(500,000)	-33.33%
Other real estate owned (OREO)	<u>3,000,000</u>	<u>500,000</u>	<u>2,500,000</u>	500.00%
<b>Total Assets</b>	<b><u>\$ 300,000,000</u></b>	<b><u>\$ 276,000,000</u></b>	<b><u>\$ 24,000,000</u></b>	<b>8.70%</b>
<b>Liabilities:</b>				
Members' share & savings accounts	\$ 274,700,000	\$ 252,500,000	\$ 23,500,000	8.79%
Accounts payable and accrued liabilities	2,350,000	2,500,000	(150,000)	-6.00%
Borrowed funds	<u>1,000,000</u>	<u>1,000,000</u>	<u>-</u>	0.00%
<b>Total Liabilities</b>	<b>278,050,000</b>	<b>256,000,000</b>	<b>22,050,000</b>	<b>8.61%</b>
<b>Members' Equity:</b>				
Regular reserve	2,500,000	2,500,000	-	0.00%
Undivided earnings	20,700,000	18,500,000	2,200,000	11.89%
Accumulated other comprehensive loss	<u>(1,250,000)</u>	<u>(1,000,000)</u>	<u>(250,000)</u>	25.00%
<b>Total Members' Equity</b>	<b><u>21,950,000</u></b>	<b><u>20,000,000</u></b>	<b><u>650,000</u></b>	<b>3.25%</b>
<b>Total Liabilities &amp; Members' Equity</b>	<b><u>\$ 300,000,000</u></b>	<b><u>\$ 276,000,000</u></b>	<b><u>\$ 24,000,000</u></b>	<b>8.70%</b>

# Note 1: Loans to Members

<i>Loans Outstanding</i>	<u>December 31, 2021</u>	<u>December 31, 2020</u>
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>
 <i>Summary of Allowance Activity</i>		
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
 <i>Reportable Delinquencies from Call Report:</i>		
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
 <i>Reportable Delinquency to Gross Loans</i>	 2.76%	 1.05%

# Rewards Federal Credit Union

## Statements of Income

	For the years ended				ROA
	December 31, 2021	December 31, 2020	2021 ROA	2020 ROA	Change
Interest income	12,000,000	11,000,000	4.17	4.14	0.03
Interest expense	<u>(1,750,000)</u>	<u>(1,500,000)</u>	<u>(0.61)</u>	<u>(0.56)</u>	<u>(0.05)</u>
Net Interest margin	10,250,000	9,500,000	3.56	3.58	(0.02)
Provision for loan losses (PLL)	<u>(750,000)</u>	<u>(1,250,000)</u>	<u>(0.26)</u>	<u>(0.47)</u>	<u>0.21</u>
Net interest income after PLL	9,500,000	8,250,000	3.30	3.11	0.19
Non-interest income	7,500,000	7,250,000	2.43	2.73	(0.30)
Non-interest expense	<u>(14,800,000)</u>	<u>(14,250,000)</u>	<u>(5.14)</u>	<u>(5.37)</u>	<u>0.23</u>
<b>Net income</b>	<b>2,200,000</b>	<b>1,250,000</b>	<b>0.59</b>	<b>0.47</b>	<b>0.12</b>

# Statement of Financial Condition = Balance Sheet

## Basic Points:

- Balance sheet prepared **for a specific day**
  - Generally monthly (i.e. **at** December 31, 2021)
- Accounting equation:  $\text{assets} = \text{liabilities} + \text{equity}$
- Assets: Things owned
- Liabilities: Things owed to third parties
- Members' equity: Difference between assets & liabilities

# Statement of Financial Condition = Balance Sheet

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- **Assets**
  - Cash on hand, in banks
  - Investments
  - Loans to members
  - Interest receivable
  - Property & equipment
  - Prepaid and other assets



# Statement of Financial Condition = Balance Sheet

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- Liabilities
  - Members' deposits
  - Borrowed funds
  - Interest payable
  - Accrued liabilities

# Statement of Financial Condition = Balance Sheet

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- **Members' Equity**
  - Undivided earnings
  - Regular reserve
  - Appropriated
  - Accumulated other comprehensive income (loss)

# Statement of Income

## Basic Points:

- Income statement prepared **for a period of time**
  - Generally monthly (for the month, quarter, etc. ended December 31, 2021)
- Revenues: Income earned from assets & services
- Expenses: Costs incurred on liabilities & services provided
- Net income (loss): Difference between revenues & expenses

# Statement of Income

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- Net income (loss)
  - Period end, net income (loss) combined into undivided earnings
  - Inadequate earnings:
    - Erodes net worth
    - Regulatory intervention (conservatorship)

# Key Ratios (Balance Sheet)

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- Loans to Shares:  
 $\$216\text{M} / \$274\text{M} = 78.6\%$
- Loans to Assets:  
 $\$216\text{M} / \$300\text{M} = 72.0\%$
- What These Ratios Mean:
  - Deposits or assets invested in loans
  - Low ratio – strict lending, low-risk tolerance, unattractive loan products
  - High ratio – attractive loan products, higher-risk tolerance, strong market programs

# Key Ratios (Balance Sheet)

- Loan growth: Change in loans divided by prior year total loans

$$\$15M (\$216M - \$201M) / \$201M = 7.5\%$$

- What This Ratio Means:
  - Overall growth, decline within the portfolio
  - Low ratio – conservative underwriting, stagnant loan environment, ineffective management
  - High ratio – aggressive, risky underwriting, booming loan environment, effective management



# Key Ratios (Balance Sheet)

- **Loan Portfolio Mix:**

	<b>December 31, 2021</b>
Real Estate	\$175,000,000 / \$216,000,000 = 81.0%
Vehicle	\$25,500,000 / \$216,000,000 = 11.8%
Unsecured	\$15,500,000 / \$216,000,000 = 7.2%
- **What You Should Know:**
  - Key characteristics, challenges of each loan portfolio segment
  - Effective loan portfolio management mix?

# Key Ratios (Balance Sheet)

- Delinquent Loan: Delinquent loans > 2 months divided by total loans

$\$5,967,500 / \$216,000,000 = 2.76\%$  as of 12/31/21

$\$2,117,000 / \$201,000,000 = 1.05\%$  as of 12/31/20

- What This Ratio Means:
  - Credit risk within the portfolio
  - Low ratio: conservative underwriting practices, charged off timely
  - High ratio: not charged off timely, collections understaffed, poor credit decisions

# Key Ratios (Balance Sheet)

- Delinquent Portfolio Mix:**

Category	December 31, 2021	December 31, 2020
2 - 6 Months	33%	64%
6 - 12 Months	49%	25%
Over 12 Months	18%	11%

- What You Should Know:**

- Charge-off policy? Timely charge-off?
- Percentage over 6 months results in losses? Allowance for loan loss impact?
- Underlying collateral evaluation?

# Key Ratios (Balance Sheet)

- Net charge-offs: Charge-offs minus recoveries divided by average loans understanding  
$$\$775\text{K} / ((\$216\text{M} + \$201\text{M}) / 2) = 1.05\%$$
- What This Ratio Means:
  - Annualized loan losses relative to the portfolio
  - Low ratio: conservative underwriting practices, not charged off timely
  - High ratio: aggressive, risky underwriting practices, weak collection efforts

# Key Ratios (Balance Sheet)

- Net worth: Regular reserve plus undivided earnings divided by total assets

$$\$2.5\text{M} + \$20.7\text{M} = \$23.2\text{M} / \$300\text{M} = 7.73\%$$

- What This Ratio Means:
  - Strong measure of financial strength
  - Low ratio: poor, insufficient earnings, high asset growth?
  - High ratio: strong earnings, low asset growth?, supports growth

# Net Worth Ratio

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- Total Assets Options:
  - Quarter-end (traditional)
  - Infrequently utilized methods
- What You Should Know:
  - Which option is used?
  - Frequent changes to attain optimal ratios?
  - Alternative methods for higher PCA levels?



# Polling Question #2

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- Which of the following is not an intangible asset?
  - a) Goodwill
  - b) Mortgage servicing rights
  - c) FHLB stock
  - d) Core deposit intangible

# Key Ratios (Income Statement)

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- Return on Assts: Net income (loss) divided by average total assets

$$\$2.2\text{M} / ((\$300\text{M} + \$276\text{M}) / 2) = 0.59\%$$

- What This Ratio Means:
  - Asset profitability (utilization)

# Key Ratios (Income Statement)

- Net Interest Margin (NIM): Interest income less interest expense divided by average total assets  
$$\$10.25\text{M} / ((\$300\text{M} + \$276\text{M}) / 2) = 3.56\%$$
- What This Ratio Means:
  - Interest earned (loans, investments) versus interest paid (deposits, borrowed funds)
  - Primary resource supporting expenses (operating, provision)

# Key Ratios (Income Statement)

- Provision for Loan Losses (PLL): PLL expense divided by average total assets

$$\$750K / ((\$300M + \$276M) / 2) = 0.26\%$$

- What This Ratio Means:
  - Amount charged to fund the ALL (losses incurred)
  - When charge-offs, delinquency and loans are increasing PLL expense and ratio generally increase (directionally consistent)

# Key Ratios (Income Statement)

- Non-interest income: Non-interest income divided by average total assets  
$$\$7.5\text{M} / ((\$300\text{M} + \$276\text{M}) / 2) = 2.60\%$$
- What This Ratios Means:
  - Other income (interchange, GAP, member abuse) generated operationally
- What You Should Know:
  - Effective generation of additional income utilizing resources available

# Key Ratios (Income Statement)

- Non-interest expense: Non-interest expense divided by average total assets

$$\$14.8\text{M} / ((\$300\text{M} + \$276\text{M}) / 2) = 5.14\%$$

- What This Ratios Means:
  - Operating costs (member, occupancy, loan servicing)
- What You Should Know:
  - High ratio (to peer)
    - Excessive branches or other operational costs

# CAMELS Rating System

- Primarily based on key ratios
  - Rates credit unions on overall soundness
  - 1 to 5 rating system (1 being the soundest)
- |   |   |
|---|---|
| C | Capital adequacy (members' equity, net worth)       |
| A | Asset quality (includes delinquencies, charge-offs) |
| M | Management (subjective rating)                      |
| E | Earnings (net income or ROA)                        |
| L | Liquidity (interest rate risk/ALM)                  |
| S | Sensitivity (market risk/credit concentrations)     |

# NCUA Sources for Credit Union Data

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- Letter to Credit Unions – State of the Credit Union Industry
- Quarterly Call Reports
- Financial Performance Report (FPR); quarterly report providing 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



# Financial Performance Report

## – Ratio Analysis

### Capital Adequacy

	2016	2017	2018	2019	2020	2021	Peer Average
Net Worth/Total Assets	9.3%	8.4%	8.3%	8.9%	7.6%	7.7%	11.3%

### Asset Quality

	2016	2017	2018	2019	2020	2021	Peer Average
Delinquent Loans/Totals Loans	1.9%	1.6%	1.8%	1.3%	1.1%	2.8%	0.8%
Net Charge-Offs/Average Loans	0.8%	2.2%	1.8%	1.7%	0.4%	0.4%	0.6%

### Asset/Liability Management

	2016	2017	2018	2019	2020	2021	Peer Average
Total Loans/Total Shares	74.7%	69.4%	84.0%	84.3%	79.6%	78.6%	78.7%
Total Loans/Total Assets	68.4%	63.1%	76.9%	77.1%	72.8%	72.0%	68.0%

# Financial Performance Report

## – Ratio Analysis

### Earnings

	2016	2017	2018	2019	2020	2021	Peer Average
<b>Return on Average Assets (ROA)</b>	0.2%	-0.7%	-0.4%	0.4%	0.5%	0.6%	0.7%
<b>Interest Income/Average Assets</b>	5.3%	4.9%	4.6%	4.4%	4.1%	4.2%	3.7%
<b>Cost of Funds/Average Assets</b>	1.8%	1.5%	1.0%	0.7%	0.6%	0.6%	0.5%
<b>Provision for Loan Losses/Average Assets</b>	0.8%	1.6%	1.4%	0.7%	0.5%	0.3%	0.4%
<b>Operating Expenses/Average Assets</b>	5.2%	5.2%	5.3%	5.3%	5.4%	5.1%	3.7%
<b>Non-Interest Income/Average Assets</b>	2.7%	2.8%	2.7%	2.8%	2.7%	2.4%	1.6%

# Polling Question #3

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- Which of the following would we expect to result in a higher provision expense?
  - a) Significant loan growth
  - b) Decrease in loan losses
  - c) Stable delinquency
  - d) Both a and c



# Possible Questions to Ask From Your Analytical Review

# Allowance for Loan Losses

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- ALL in 2021 is lower than 2020?
  - Loans increased
  - Delinquency nearly tripled
  - Recovery payments down \$50,000 (33.3%) this year (\$100,000) versus last year (\$150,000)?
- Management adhering to the charge-off policy?

# Possible Problems Identified

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- Allowance for Loan Losses:
  - Inadequate reserve (DQ, foreclosures)
  - Insufficient collection efforts
  - Overstated loans, net income, undivided earnings by \$2M
- Other Real Estate Owned (OREO):
  - Transferred at loan balance versus fair value
  - Overstated assets, net income, undivided earnings by \$1.5M

# Possible Problems Identified

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- Net Income/ROA Ratio:
  - Net income \$2.2M and ROA 0.59%
  - Net loss (\$1.3M) and negative ROA (0.45%)
- Retained Earnings/Net Worth Ratio:
  - \$23.2M retained earnings and net worth ratio 7.73% (well)
  - \$19.7M retained earnings and net worth ratio 6.57% (adequately)





# Call Reporting Requirements for Credit Unions



# What is Included?

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- 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

# What is Included?

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- 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)



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Thank You!