Chapter 15

PROFITABILITY

TABLE OF CONTENTS

Chapter 15

PROFITABILITY

Examination Objectives

- Review income and expense trends
- Analyze budget projections and practices
- Evaluate due diligence by management of services and products affecting the credit union's profitability (e.g., cost-benefit analysis)
- Determine adequacy of policies and practices addressing income and expenses
- Compare actual performance to the income and expense budget and capitalization goals
- Determine sufficiency of earnings to cover operating expenses, dividends, and necessary reserve transfers
- Determine adequacy of earnings to increase the net worth ratio (if necessary) or to maintain the net worth ratio at or above established benchmarks
- Ensure compliance with applicable laws, regulations, accounting practices, and policy statements when recording income and expense items
- Determine that management has instituted prompt correction of deficiencies or exceptions

Associated Risks

- Credit risk can result from poor underwriting of loans or high-risk investments;
- Interest rate risk can result from insufficient net interest margin to cover operating expenses;
- Liquidity risk can result from inadequate pricing policies, and failure to properly structure share and loan products resulting in weak or negative profitability;
- Strategic risk can result from failure of management to plan for sufficient resources to fulfill business plans or continue offering competitive products and services; and
- Reputation risk can result from loss of member confidence and withdrawal of member shares due to questions regarding the credit union's on-going viability.

Statement of Income

The Statement of Income displays basic information about a credit union's profitability. This workpaper compares profitability from the prior yearend to the current period. The examiner can tailor the workpaper to calculate the individual line items as a percentage of either total assets, average assets, total income, or total expenses. The Financial History and Key Ratios workpapers display profitability trends for prior periods.

If the credit union has a profitability problem, the examiner will evaluate the cause of the deficiency. Examiners may prepare additional schedules or custom worksheets to analyze specific items (e.g., fee income, miscellaneous income, cash over and short, travel and conference expense, operating expenses, professional and outside services, miscellaneous expense, or any non-operating expense).

Pro-Forma Estimations

Examiners may find it necessary to estimate material items such as dividends, reserve transfers, operating income, and operating expenses (if they are not accrued) during an examination or supervision contact performed as of a date other than the end of an accounting period. The estimates can reveal whether the credit union has sufficient earnings to declare its anticipated dividend. It will also show the net effect the dividend will have on net worth. Calculation of estimated dividends may require averaging the prior two periods' dividend-to-shares ratio (taking into account any expected changes in dividend rates) and multiplying the ratio by the average shares outstanding since the prior dividend period.

> **Example**: Assume a September 30 examination in a credit union that offers only regular shares and pays dividends semiannually. As of June 30, the average share balance for the quarter was $350,000 and dividends totaled $3,938. The dividend-to-shares ratio is $3,938/$350,000 = .01125.
>
> On December 31 of the prior year, the average share balance for the 6-month period was $400,000 and the dividend cost was $4,700. The dividend-to-shares ratio is $4,700/$400,000 = .01175. The average of the prior two periods' dividend-to-shares ratio is 1.15 percent ((1.125 percent + 1.175 percent)/2).
>
> Assume July 31 shares totaled $475,000, August 31 shares totaled $500,000, and September 30 shares totaled $525,000. Average shares is ($475,000 + $500,000 + $525,000)/3 = $500,000. Multiplying the average shares by the dividend-to-shares ratio yields $500,000 x 1.15 percent = $5,750, which is the current period's estimated dividend. As of the examination date, the credit union has recorded only one-half or $2,875 as the estimated dividend. The effective annual cost of shares is the result of multiplying the dividend-to-

shares ratio by the number of dividend periods in a year (2 x 1.15 percent = 2.3 percent cost of shares).

Analysis of Profitability

The Total Analysis Process chapter identifies procedures to properly assess profitability as it relates to the credit union's CAMEL rating and further discusses the ratios described in this chapter. A review of profitability should include a review of the credit union's general financial condition. A credit union with a weak net worth ratio requires strong profitability to improve net worth. In contrast, a credit union with strong net worth may only need profitability adequate to maintain its current position. Other considerations include asset growth, loan loss history, expense trends, growth projections and goals, and economic factors such as sponsor stability.

The Key Ratios workpaper displays the Earnings Ratios further described in the Total Analysis Process chapter. The examiner may supplement the foregoing analysis with data from the Financial Performance Report (FPR).

When reviewing profitability, examiners may evaluate several fundamental ratios. These include (1) the yield on assets, (2) cost of funds to average assets, (3) operating expenses to average assets, (4) net operating expenses to assets, and (4) return on average assets.

In some instances, unusual accounting period entries could distort profitability ratios. For example, recording large "one time" expense items could distort operating expense, while reflection of substantial point fee income from the sale of mortgage loans could distort income. Another distortion can occur when the examiner performs an examination early in the year in a credit union having unusual income or expense items because annualizing the income and expense items magnifies their effect. Annualizing assumes that income and expenses will occur consistently throughout the year, which may not fit the situation at hand.

If profitability concerns the examiner, the examiner may complete the Two Minute Profitability Test. This workpaper displays the profit necessary to maintain the current net worth ratio under varying growth rate assumptions. The examiner can tailor this worksheet to indicate the additional profit necessary to increase the net worth ratio to a specified level over a selected number of years.

Examiners can also use the Two Minute Profitability Test for reviewing the credit union's budget relative to its net worth goals.

Gross Income to Average Assets

The gross income to average assets ratio reflects the rate at which the assets produce income. Since assets include such non-earning items as prepaid expenses and furniture and equipment, this ratio usually is less than the credit union's interest rate on loans. If the credit union has a low gross income to average assets ratio, or a negative or declining trend, the examiner may extend the analysis to determine the cause of the decreased income. Individually analyzing the yield on loans, yield on investments, and other major assets can assist the examiner in this determination. If these ratios do not point out the cause of the adverse trend, the examiner may look for a major fixed-asset purchase or some other increase in non-earning assets (e.g., the volume of delinquent loans greater than 90 days.)

Yield on Loans

The yield on loans is the rate at which loans produce income. This ratio usually is less than the interest rate charged for loans because it does not consider unaccrued interest on delinquent loans. Examiners should determine the reasonableness of the yield on loans for the types of loans in the credit union's portfolio. The yield on loans should not deviate substantially from the weighted average interest rate charged on loans. If the yield on loans reflects a negative trend, the reasons may include an increase in delinquency, decreased collections, or a reduction in interest rates.

Operating Expenses to Average Assets

Operating expenses to average assets reflects the percentage of assets used for operations. If this ratio is high or if there is an increasing trend, examiners should determine the cause.

Net Operating Expenses to Average Assets

Net operating expenses to average assets considers net operating cost when evaluating operating expenses. Fee income reduces total operating expenses. This ratio tends to put the overall expense picture into focus for those credit unions that offer expensive services but recoup some or all of the costs by assessing fees.

Comparison of this ratio with the operating expenses to average assets ratio provides additional information about the degree to which the credit union depends on fee income.

Cost of Funds to Average Assets

Cost of funds to average assets reflects the percentage of assets used for dividends and interest on borrowed money. Examiners should determine the cause of a high ratio or increasing trend. Calculating the cost of various share types and the cost of borrowed money ratios can assist in this determination. The mix of deposits between lower-costing regular shares and higher-costing share certificates directly affects the cost of shares. By reviewing growth trends by share category, examiners can better isolate changes.

Net Interest Margin to Average Assets

The net interest margin to average assets ratio measures whether income from loans and investments sufficiently covers the cost of funds. In general terms, if the credit union properly matches assets and liabilities, this ratio should remain constant in varying interest rate cycles. A fluctuating ratio could indicate a change in loan rates charged, a change in investment practices, or (in a rapidly changing rate environment) a slow adjustment of dividend rates paid. Examiners may determine the cause of a low or fluctuating ratio.

Return on Average Assets

The return on average assets ratio is the percentage of assets that the credit union realizes as profit before reserve transfers. A negative trend usually indicates a problem that requires addressing with the officials or, if material, in the examination report. A negative ratio may require the examiner to determine the cause and help officials develop corrective actions. The urgency of the situation depends on the degree of negativity in the trend and the amount of available reserves. Available revocable reserves and earnings determine how long the credit union can support negative earnings without affecting dividends or operations.

Example: If a $2 million credit union has $22,000 in Undivided Earnings and a Net Loss From Operations ratio of -0.6 percent, the credit union will lose 0.6 percent times $2,000,000 per year, or $12,000 under present conditions.

Therefore, the credit union has 22 months or less to improve operations. However, if the -0.6 percent were the 12-month ratio, and the latest three-month ratio is -0.9 percent, the trend indicates an accelerating loss rate and dramatically reduces the period in which corrections must take place.

To determine the longest time available, examiners should first calculate the annual loss and then convert it into months:

$2,000,000 x -0.9 percent = $18,000 / 12 months = $1,500 loss per month.

At that rate, the credit union will deplete its $22,000 in Undivided Earnings in a maximum 15 months.

The accelerating loss rate may reduce the maximum period. Unless management makes changes, the credit union has less than 15 months in which to operate. A review of the ratio should reveal the validity of this assumption, or determine if less time actually remains to correct the problem.

Once identified, examiners should work with the credit union to correct the problems causing the negative trend. Examiner-designed workpapers may assist in determining and documenting the causes of the negative trends and lead toward corrective action in the Document of Resolution. When necessary, the examiner may choose to use the Supplementary Facts or any examiner-designed workpaper to highlight and explain the key ratios to the officials to increase their understanding.

Workpapers

- Workpapers
  - Financial History
  - Key Ratio
  - Statement of Income
  - Two Minute Profitability Test