 Office of Credit Unions Policies and Procedures	POLICY NUMBER
	10820
NET WORTH AND EARNINGS	EFFECTIVE DATE
	11/01/2018
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I. PURPOSE


Earnings must be evaluated relative to net worth needs, financial and operational risk exposures, the current economic climate, and the institution's strategic plans. Examiners must ensure current earnings and net worth are accurately stated, earnings are managed appropriately, and proper internal controls exist over expenditures and reserves.

II. PRIMARY REFERENCES / RELATED REGULATIONS


1. Michigan Credit Act:
 - a. [Section 342 \(3\)\(d\): Approving annual operating budget](#)
 - b. [Section 342 \(4\)\(g\): Establishing internal controls](#)
 - c. [Section 362: Dividend; declaration, payment, amount, etc.](#)
 - d. [Section 382: Fiscal year; accounting principles](#)
 - e. [Section 386: Establishment and maintenance of reserves](#)
 - f. [Section 401: Domestic credit union; powers](#)
2. [NCUA Rules and Regulations, Part 741.1: Insurance premium](#)

III. MINIMUM PROCEDURES

1. To ensure earnings are accurately stated:
 - a. Analyze income and expense ratios and determine causes of unusual trends.
 - i. Inordinately high net income could indicate:
 1. Taking on additional risk in the investment or loan portfolio.
 2. Not providing competitive dividend or loan rates.
 3. Not providing adequate services for the membership.
 4. Not planning for new services or infrastructure to support the credit union in the future.
 5. Undue reliance on fee income to support operations.
 6. Management or board goals for high net income levels given ties (implicit or explicit) to bonuses, salaries, or performance evaluations.
 - ii. Inordinately low net income could indicate:
 1. Inefficient operations resulting in high or out of control expenses to the detriment of the membership. Examiners will continue to address high operating expenses as a problem area if they do not involve an intentional increase in the credit union's investment in infrastructure

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- (technology, new services, increased training, etc.) as part of a documented, sound strategic plan.
2. Exorbitant compensation systems misaligned with member benefits and the mission of the credit union.
 3. Inadequate pre-planning for new services.
 4. High level of non-earning assets not aligned with the strategic needs of the credit union.
 5. Economic disruption impacting the field of membership.
 6. Unsafe dividend levels attracting volatile share growth.
 7. High loan losses due to poor credit quality loans.
- iii. The fact that net income is relatively high or low is not by itself evidence there is a problem. Rather, it is merely a trigger for examiners to thoroughly review the earnings structure to determine the underlying factors that result in the performance. Examiners should assess these factors in relation to the institution's overall condition, consistency with the mission, and congruence with the strategic plans and budgets.
 - b. Compare income and expense accounts to system-generated reports, invoices, and statements.
 - c. Review calculations of material accrued income receivable accounts and accrued expense payable accounts to determine if adjustments to revenue and expense accounts are accurate.
 - d. Review the Allowance for Loan and Lease Account (and any other account representing management estimates) to determine if the methodology is sound, and not inappropriately distorting earnings.
2. To determine appropriate management of earnings:
 - a. Ensure the Board of Directors approved a budget prior to the start of the fiscal year.
 - b. Review the budget to ensure it is realistic and reflects all new and modified programs, services, expenses, and sources of revenue.
 - c. Compare the budget for consistency with the strategic plan, business plan, and goals.
 - d. Compare actual with budgeted year-to-date expenses and revenues and ensure causes of all material variances are documented.
 - e. Determine the effects on net worth of any expected net loss for the year.

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- f. Review key ratios and compare to peer ratios, investigate reasons for adverse ratios, and determine necessary corrective action, as applicable.
 - g. Review management’s cost-benefit analysis of new or higher risk programs and services to determine the impact on earnings.
3. To ensure proper internal controls exist over expenses and revenues:
- a. Review minutes for Board of Directors approval of monthly expenses after the fact.
 - b. Review policies and minutes for Board approval of large, non-routine expenditures and contracts before obligations are incurred.
 - c. Review Capitalization Policy for reasonable threshold over which to capitalize an asset as opposed to immediately expensing it.
 - d. Review depreciation and amortization periods for reasonableness.
 - e. Ensure depreciation and amortization start when appropriate.
 - f. Examine a sample of material expenses and revenues to ascertain the existence of supporting invoices/statements/receipts, the business purpose for the expense, the separation of expense approval and processing functions, and the separation of revenue receipt and recording functions.