

# BOARD DUE DILIGENCE NOW AND IN THE FUTURE

Jim Patterson

Sherman & Patterson, Ltd.

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# Overview

- ▣ New Rule 701.4
- ▣ Sample Balance Sheet & Income Statement
- ▣ Cash Compensation Philosophy
- ▣ Example of WesCorp Litigation
- ▣ 10 Best Practices of Compensation Oversight by Board
- ▣ Q&A's

# Rule 701.4

- ▣ Describes duties of FCU boards of directors
- ▣ Effective January 27, 2011
- ▣ Financial skills requirements take effect on July 27, 2011 (6-month training period for new directors)
- ▣ NCUA letter of clarification (11-FCU-02) February 2011

# Rule 701.4

- ▣ Five director duties
  - General direction and control
  - Good faith – ordinarily prudent person standard
  - Fair and impartial
  - Working familiarity with finance and accounting practices
  - Direct FCU operations according to federal laws

# Rule 701.4

- ▣ Can rely on information from employees or consultants  
– must “merit confidence”

# Rule 701.4

- ▣ Financial Statements
  - What does this line item mean?
  - Why is it important?
    - ▣ Is the item's value changing over time? Why?
    - ▣ Is the change important?

# Sample Balance Sheet

## Supplemental Executive Benefit Plan PRO FORMA BALANCE SHEET

Hypothetical Illustrations for Sample Credit Union



	Balance Sheet as of 12/31/2010	Hypothetical Change	Hypothetical Alternative Result
Cash & Equivalents	\$ 2,436,263	\$ (800,000)	\$ 1,636,263
Total Investments	27,199,284	-	27,199,284
Loans Held for Sale	0	-	0
Real Estate Loans	17,354,034	-	17,354,034
Unsecured Loans	2,652,895	-	2,652,895
Other Loans	4,425,701	-	4,425,701
(Allowance for Loan & Lease Losses)	(172,441)	-	(172,441)
Land and Building	1,454,278	-	1,454,278
Other Fixed Assets	80,983	-	80,983
NCUSIF Deposit	453,093	-	453,093
All Other Assets	202,667	800,000	1,002,667
<b>TOTAL ASSETS</b>	<b>\$ 56,086,757</b>		<b>\$ 56,086,757</b>

### ASSUMPTIONS

- Hypothetical investment amount: \$800,000
- Based on most recent available financial data with actual transaction date(s) to occur in the future.

# Sample Income Statement

## Supplemental Executive Benefit Plan PRO FORMA INCOME STATEMENT

Hypothetical Illustrations for <Insert Credit Union Name Here>



*Values based on current assumptions. Actual results may vary.*

	Financial Results for Period Ending: 12/31/2010	Hypothetical Change	Hypothetical Alternative Results
Loan Income	\$ 33,259,417		\$ 33,259,417
Investment Income	10,757,912	\$ 546,511	11,304,423
Other Income	18,049,049		18,049,049
Salaries & Benefits	(14,967,187)		(14,967,187)
Temporary Corporate CU Stabilization Expense & NCUSIF Premiums	(3,735,340)		(3,735,340)
Total Other Operating Expenses	(16,484,373)		(16,484,373)
Non-operating Income & (Expense)	460,377		460,377
NCUSIF Stabilization Income	0		0
Provision for Loan and Lease Losses	(10,195,540)		(10,195,540)
Cost of Funds	(10,883,299)		(10,883,299)
<b>NET INCOME</b>	<b>\$ 6,261,016</b>	<b>\$ 546,511</b>	<b>\$ 6,807,527</b>
<b>HYPOTHETICAL RETURN ON ASSETS</b>	<b>0.6214%</b>	<b>0.0542%</b>	<b>0.6757%</b>

### ASSUMPTIONS

- Transaction date: 1/1/2010
- Percentage of Capital to be Invested: 25.00%
- Available Capital on Investment Date: 98,470,433
- Hypothetical investment amount: **\$24,617,608**
- The institution's current yield on average investments: 2.28%
- The projected first year yield on alternative investments: 4.50%
- The institution's total assets on the transaction date: \$1,004,784,089

# Line Items

Line Item	Dec-09	Mar-10	%Chg	Jun-10	%Chg	Sep-10	%Chg	Dec-10	%Chg
	Amount	Amount		Amount		Amount		Amount	
<b>ASSETS:</b>									
Cash & Equivalents	88,790,342	131,015,108	47.6	118,005,274	-9.9	84,364,130	-28.5	69,682,615	-17.4
<b>TOTAL INVESTMENTS</b>	389,109,426	364,508,465	-6.3	403,680,119	10.7	423,814,205	5	415,116,428	-2.1
Loans Held for Sale	1,249,600	951,600	-23.8	480,500	-49.5	2,008,774	318.1	2,358,278	17.4
Real Estate Loans	225,604,566	222,728,670	-1.3	222,155,136	-0.3	221,618,831	-0.2	203,188,690	-8.3
Unsecured Loans	88,600,852	87,209,049	-1.6	88,437,591	1.4	88,776,772	0.4	89,709,394	1.1
Other Loans	176,488,686	176,121,334	-0.2	176,026,401	-0.1	183,331,479	4.1	187,865,441	2.5
<b>TOTAL LOANS</b>	490,694,104	486,059,053	-0.9	486,619,128	0.1	493,727,082	1.5	480,763,525	-2.6
(Allowance for Loan & Lease Losses)	-11,352,281	-11,277,950	-0.7	-9,781,345	-13.3	-10,388,340	6.2	-8,805,909	-15.2
Land And Building	21,712,273	21,656,863	-0.3	23,934,832	10.5	23,906,362	-0.1	24,162,318	1.1
Other Fixed Assets	7,974,787	7,664,756	-3.9	7,322,452	-4.5	7,011,756	-4.2	7,124,583	1.6
NCUSIF Deposit	8,326,133	8,326,133	0	8,336,769	0.1	8,336,769	0	8,661,947	3.9
All Other Assets	8,279,705	14,670,137	77.2	10,265,240	-30	10,302,909	0.4	32,219,804	212.7
<b>TOTAL ASSETS</b>	1,004,784,089	1,023,574,165	1.9	1,048,862,969	2.5	1,043,083,647	-0.6	1,031,283,589	-1.1
<b>LIABILITIES &amp; CAPITAL:</b>									
Dividends Payable	969	930	-4	489	-47.4	797	63	740	-7.2
Notes & Interest Payable	0	0	0	0	0	0	0	0	0
Accounts Payable & Other Liabilities	8,608,737	9,196,506	6.8	10,160,759	10.5	12,103,137	19.1	10,198,461	-15.7
Uninsured Secondary Capital	0	0	0	0	0	0	0	0	0
<b>TOTAL LIABILITIES</b>	8,609,706	9,197,436	6.8	10,161,248	10.5	12,103,934	19.1	10,199,201	-15.7
Share Drafts	87,352,657	88,555,745	1.4	88,529,500	0	94,163,864	6.4	94,383,223	0.2
Regular shares	257,032,317	274,123,974	6.6	275,625,224	0.5	286,551,043	4	294,279,734	2.7
All Other Shares & Deposits	553,318,976	552,260,618	-0.2	570,128,422	3.2	544,293,160	-4.5	529,481,177	-2.7
<b>TOTAL SHARES &amp; DEPOSITS</b>	897,703,950	914,940,337	1.9	934,283,146	2.1	925,008,067	-1	918,144,134	-0.7
Regular Reserve	35,506,241	35,506,241	0	35,506,241	0	35,506,241	0	35,506,241	0
Other Reserves	3,717,570	3,038,254	-18.3	5,791,691	90.6	5,634,967	-2.7	1,926,376	-65.8
Undivided Earnings	59,246,622	60,891,897	2.8	63,120,643	3.7	64,830,438	2.7	65,507,637	1
<b>TOTAL EQUITY</b>	98,470,433	99,436,392	1	104,418,575	5	105,971,646	1.5	102,940,254	-2.9
<b>TOTAL LIABILITIES, SHARES, &amp; EQUITY</b>	1,004,784,089	1,023,574,165	1.9	1,048,862,969	2.5	1,043,083,647	-0.6	1,031,283,589	-1.1
<b>INCOME &amp; EXPENSE:</b>									
Loan Income*	31,472,513	8,216,680	4.4	16,525,981	0.6	24,816,678	0.1	33,259,417	0.5
Investment Income*	15,442,991	3,121,244	-19.2	5,424,092	-13.1	8,253,164	1.4	10,757,912	-2.2
Other Income*	16,264,555	4,136,183	1.7	8,669,044	4.8	13,189,119	1.4	18,049,049	2.6
Salaries & Benefits*	13,403,000	3,565,308	6.4	7,191,469	0.9	10,868,432	0.8	14,967,187	3.3
Temporary Corporate CU Stabilization Expense & NCUSIF Premiums* \2	1,457,073	0	-100	1,347,501	0	0	-100	3,735,340	0
Total Other Operating Expenses*	14,423,876	4,460,482	23.7	6,738,580	-24.5	15,115,781	49.5	16,484,373	-18.2
Non-operating Income & (Expense)*	1,535,397	155,483	-59.5	97,839	-68.5	116,858	-20.4	460,377	195.5
NCUSIF Stabilization Income*	4,683,664	0	-100	0	0	0	0	0	0
Provision for Loan/Lease Losses*	14,019,600	3,021,700	-13.8	4,473,700	-26	6,348,400	-5.4	10,195,540	20.5
Cost of Funds*	18,662,163	2,936,825	-37.1	5,744,184	-2.2	8,459,390	-1.8	10,883,299	-3.5
<b>NET INCOME (LOSS) EXCLUDING STABILIZATION EXPENSE &amp; NCUSIF PREMIUM * \1</b>	7,433,408	1,645,275	-11.5	5,221,522	58.7	5,583,816	-28.7	9,996,356	34.3
Net Income (Loss)*	5,976,335	1,645,275	10.1	3,874,021	17.7	5,583,816	-3.9	6,261,016	-15.9

# Line Item Columns

- ▣ Line Item
- ▣ December 2009
- ▣ March 2010
- ▣ **% Change**
- ▣ June 2010
- ▣ **% Change**
- ▣ ...

# Rule 701.4

- ▣ Must understand FCU's specific activities
- ▣ Must understand the various risks:
  - Credit
  - Liquidity
  - Interest rate
  - Compliance
  - Strategic
  - Transaction; and
  - Reputation

# Rule 701.4

- ▣ Timetable
  - 6 months, for those without financial skills, whether new or currently serving
- ▣ How to acquire financial skills
  - FCUs need training policy providing:
    - ▣ Internal/external training, self, on-the-job
    - ▣ Education: college courses, OSCUI, NCUA E&I internet-based training

# Rule 701.4

- ▣ Management oversight
  - Board, among other things, must directly set compensation
  - Establish policies
  - No “screening” or “filtering” from CEO
- ▣ Members’ interests
  - Serve the members of the FCU
    - ▣ What services do members want?
    - ▣ Will decision help to provide the services?

# Compensation Philosophy

- ▣ Guiding principles and objectives
  - Purposes
  - Specify degree of leverage
  - Peer group compensation standards – Address salary levels, incentive compensation, benefits and perquisites
  - In writing and signed by Board Chair
- ▣ Administrative Responsibility
  - Monitor compensation regularly to ensure consistency with the compensation philosophy
  - Delegate day-to-day responsibilities to CEO or other executive

# WesCorp

- ▣ One side of the story
- ▣ Seeking damages from key executives for SERP payments
- ▣ Illustrates importance of process
  - Active Board involvement
  - Third party review
  - Documentation of intent
  - Executive session

# 10 Best Practices of Compensation Oversight

- ▣ Develop compensation philosophy
- ▣ Specify covered positions
- ▣ Seek comparability data
- ▣ Annually review compensation
- ▣ Consider multiplier effect

# 10 Best Practices of Compensation Oversight

- ▣ Engage periodic consultant review
- ▣ Consultants report to the board
- ▣ Inspect plan modifications
- ▣ Ensure plan documentation is compliant
- ▣ Associate with professionals to monitor legal developments

# Q&A