Earnings

Examiners should evaluate the above-captioned function against the following control and performance standards. The Standards represent control and performance objectives that should be implemented to help ensure the bank operates in a safe and sound manner, and that the entity's objectives are carried out. Associated Risks represent potential threats to the bank if the standards are not achieved and maintained. The Standards are intended to assist examiners in analyzing important functions that may warrant additional review. All of the following Standards may NOT need to be considered at every bank. Conversely, these do NOT represent all of the control and performance standards needed for every bank. Examiners should continue to use their judgement when assessing risk.

Standards	Associated Risks
MANAGEMENT AND CONTROL	
Management develops a profit plan consistent with the bank's strategic objectives. Management prepares a realistic budget. Management compares actual performance to projections on a periodic basis.	Profit objectives may be incompatible with business activities. Earnings trends or gradual deterioration of profitability may be misinterpreted or unnoticed. Operating objectives may not be achieved. Management may fail to evaluate the impact of growth and operating strategies.
Budget assumptions are reasonable.	Management's ability to recognize and correct deficiencies can be impeded by unrealistic expectations. Usefulness of the budget for comparative purposes can be nullified by unrealistic assumptions. Unreasonable assumptions may compromise long-term earnings potential by overemphasizing short-term performance.
Management has established adequate internal controls over bank revenues and expenses.	Weak controls may increase the bank's exposure to errors and omissions and impair accurate accounting of bank activities. Inadequate controls increase the potential for fraud and abuse.
Independent reviews and audits discuss deficiencies in bank accounting.	Identification, communication, and correction of deficiencies may be inadequate.
Information systems and management reports provide accurate information concerning earnings performance.	The board of directors may be inadequately informed and unable to properly evaluate earnings performance. Consolidated Reports of Income and Condition and published statements could be inaccurate.
Management's risk orientation does not expose earnings to adverse fluctuations.	Management may sacrifice prudent underwriting standards or investment criteria for higher-yielding, higher-risk asset activities to improve earnings.
Management controls growth.	Overly aggressive efforts to stimulate growth may have detrimental long-term effects on earnings (loan losses, increased interest expense, etc.).

Standards	Associated Risks
PERFORMANCE	
The level of earnings is sufficient to support operations and maintain capitalization. The level of earnings is appropriate for the bank's risk profile.	Capital protection may be adversely affected if earnings are insufficient to absorb losses. Lack of profitability may compromise the ability of the bank to withstand asset quality problems, interest rate movements, or variances in non-interest income and expenses. Earnings may be insufficient to augment capital and thus support asset growth.
The quality of earnings is satisfactory.	Earnings can decline in the future as risks arising from short-term strategies become evident or nonrecurring sources of income diminish. The level of earnings can not be sustained. Decline of income from operational sources can be overshadowed or obscured by nonrecurring sources of income. Pursuit of nonrecurring income can result in increased credit risk or market risk via imprudent securities activities, asset sales, fee-based lending, or other means.
Interest income is commensurate with the composition and risk profile of the bank's earning assets.	Unusually high or low yields relative to earning asset composition may indicate excessive risk-taking practices or an inability to properly price products. (Either situation elevates the risk to earnings and capital.)
Interest expense is properly controlled.	Inability to control funding costs can depress the net interest margin. Funding decisions and pricing strategies may not be economically prudent.
The net interest margin is sufficient to cover normal overhead expense.	The bank may be structurally unprofitable. Poor pricing strategies may result in the bank not being compensated for risks taken. Management may not be collecting interest owed on problem loans.
Overhead expenses are adequately controlled.	Profitability can be impaired by excessive overhead expenses. Burdensome overhead expenses may encourage management to engage in riskier activities to generate earnings.
Earnings are not materially impacted by excessive or improperly managed credit risk.	High levels of non-earning assets can depress the net interest margin. Significant loan portfolio deterioration can result in material provisions for losses.

Standards	Associated Risks
	Overhead expenses may increase due to costs associated with disposition of non-earning assets.
Earnings are not unduly vulnerable to interest rate fluctuations.	The net interest margin or other interest rate sensitive sources of income may be adversely impacted by interest rate movements.
Earnings are stable.	Erratic profitability or long-term decline of earnings can impair ability to augment capital. Material fluctuation of earnings can erode public confidence.

Earnings

Core Analysis Decision Factors

Examiners should evaluate Core Analysis in this section for significance and to determine if an Expanded Analysis is necessary. Negative responses to Core Analysis Decision Factors may not require proceeding to the Expanded Analysis. Conversely, positive responses to Core Analysis Decision factors do not preclude examiners from proceeding to the Expanded Analysis if deemed appropriate.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

Core Answer: General Comment:(If any)

Core Analysis Decision Factors

C.1. Are profit planning and budgeting practices adequate?

C.2. Are internal controls adequate?

C.3. Are the audit or independent review functions adequate?

C.4. Are information and communication systems adequate and accurate?

C.5. Are earnings at a level appropriate for the bank's risk profile?

C.6. Are earnings sustainable?

C.7. Do the board and senior management effectively supervise this area?

Earnings

Expanded Analysis Decision Factors

This section evaluates the significance and materiality of deficiencies or other specific concerns identified in the Core and Expanded Analyses.

Do Expanded Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

Expanded Answer: General Comment:(If any)

<u>Expanded Analysis Decision Factors</u>

E.1. Are management and control of earnings functions satisfactory?

E.2. Are earnings deficiencies or fluctuations immaterial?

Earnings

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

PRELIMINARY REVIEW

1 Review previous reports of examination, prior examination work papers, and file correspondence for an overview of any previously identified earnings concerns.

2 Review the most recent audits and independent reviews and identify deficiencies concerning reliability of information systems that may affect quality and reliability of reported earnings.

3 Review management's remedial actions to correct examination and audit deficiencies.

4 Discuss with management any recent or planned changes in strategic objectives and their implications for profit plans.

5 Review board and committee minutes and management reports to determine the level and quality of management information systems.

6 Review recent Uniform Bank Performance Reports to develop an initial assessment of overall earnings performance. Consider the impact of Chapter S tax filing status when selecting performance ratios to review.

PROFIT PLANNING AND BUDGETING PRACTICES

7 Review profit plans and budgets for years analyzed to determine if underlying assumptions are realistic. Profit plans and budgets should address the following areas with sufficient detail to match the size and complexity of the bank.

7A Anticipated level and volatility of interest rates.

7B Local economic conditions.

7C Funding strategies, including E banking initiatives.

7D Asset and liability mix and pricing.

7E Growth objectives.

7F Interest rate and maturity mismatches.

8 Determine if management compares budgeted performance to actual performance on a periodic basis and modifies projections when interim circumstances change significantly.

9 Compare earnings performance relative to budget forecasts.

INTERNAL CONTROLS

10 Review management's procedures to prevent, detect, and correct errors and inaccuracies.

11 Determine if income and expense posting, reconcilement, and review functions are independent of each other. Consider testing selected income and expense activity to observe the operational flow of transactions. Areas commonly selected for review are:

11A Large volumes of other income (miscellaneous, service fees, or any other unusual accounts).

11B Proper treatment of loan origination fees per SFAS 91.

11C Insider expense accounts.

11D Management fees or other payments to affiliates.

11E Significant legal fees.

12 Determine if significant income, expenses, and capital charges are reviewed and authorized.

13 Determine if insider related items are routinely reviewed for authorization and appropriateness.

AUDIT OR INDEPENDENT REVIEW

14 Determine that the audit or independent review program provides sufficient review relative to the bank's size, complexity, and risk profile. These activities should:

14A Recommend corrective action when warranted.

14B Verify implementation of corrective action.

14C Assess separation of duties and internal controls.

14D Determine compliance with profit planning objectives, accounting standards, and Consolidated Report of Income Instructions.

14E Assess the adequacy, accuracy, and timeliness of reports to senior management and the board.

14F Include sufficient transaction testing to provide assurances income and expenses are accurately recorded in appropriate periods.

INFORMATION AND COMMUNICATION SYSTEMS

15 Determine if managerial reports provide sufficient information relative to the size and risk profile of the institution.

16 Evaluate the accuracy and timeliness of reports produced for the board and executive management. These may include:

16A Periodic earnings results.

16B Budget variance analyses.

16C Income projections.

16D Large item reviews.

16E Insider related transaction disclosures.

16F Tax planning analyses.

17 Validate the accuracy of Reports of Income where necessary. Use bank work papers, the general ledger, downloaded exception reports, and interviews with bank personnel to verify the accuracy of Consolidated Reports of Income and Condition schedules RI, RI-A, RI-B, RI-C, and RC-K.

RATIO AND TREND ANALYSIS

18 Assess the level, trend, and sustainability of return on average assets relative to historical performance, peer comparisons, the organization's risk profile, and local economic conditions. Review and determine areas needing further investigation. Possible indicators of existing or impending problems include:

18A Material fluctuations in the return on average assets.

18B Inordinately high or low return on assets.

18C Poor profitability.

18D Significant variation of adjusted return on average assets from return on average assets.

18E Poor core earnings.

18F Increasing volatility or unfavorable trends.

18G Significant deviations from budget projections.

19 Evaluate the level and stability of the bank's net interest margin.

20 Evaluate the level and trend of overhead expenses.

21 Evaluate the level, trend, and sources of non-interest income.

22 Review the level and trend of provisions for loan and lease losses to determine the impact of asset quality on earnings. Consider the Adjusted Net Operating Income to Average Assets relationship.

23 Review the level and trend of non-operating gains and losses and their impact on earnings.

24 Evaluate the level and trend of income tax payments recognizing the institution’s basis for filing taxes.

25 Evaluate the earnings impact of activities with affiliated organizations.

BOARD AND SENIOR MANAGEMENT SUPERVISION

26 Determine if board records document routine attention to bank earnings and timely responses to significant budget deviations.

27 Assess compliance with bank policies, applicable regulations, and governing accounting standards.

Earnings

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. Expanded procedures associated with Core Analysis and Decision Factors of no concern need not be used. The flexible guidelines specified for the Core Analysis also apply here.

PROFIT PLANNING AND BUDGETING PRACTICES

1 Assess the significance and determine causes of budgeting deficiencies. Examiners should address areas that do not appear realistic in the comment section of the Risk Management pages. (FDIC)

2 Consider requesting revised budget projections using modified assumptions.

INTERNAL CONTROLS

3 Determine the causes and potential impact of inadequate accounting or reporting practices on earnings.

4 Verify source documents to general ledger entries to determine if errors on Consolidated Reports of Income and Condition are influencing performance ratio levels and trends.

5 Where internal controls are deemed insufficient, consider transaction testing to verify the authorization, propriety, and accuracy of reviewed activity.

AUDIT OR INDEPENDENT REVIEW

6 Research deficiencies cited in audit or independent review findings to determine the underlying causes and assess management's corrective efforts.

7 Consider expanding examination activities in areas of concern.

INFORMATION AND COMMUNICATION SYSTEMS

8 Assess the significance of internal management reporting deficiencies and determine underlying causes.

9 Determine needed changes in report distribution.

10 Consider detailed review of Consolidated Reports of Income and Condition information where significant errors are indicated.

10A Request revised filing where identified errors are material and revise Report of Examination data where necessary.

10B Assess the competency of the Consolidated Reports of Income and Condition preparer.

RATIO AND TREND ANALYSIS

11 Determine the underlying reasons for a low or erratic return on average assets and discuss management's plans to improve performance.

12 Ascertain if low or inconsistent Net Interest Margin is the result of asset levels, yields, and composition or the level, composition, and costs of funding.

13 Where earnings concerns derive from interest income levels, determine the underlying cause. Potential reasons for depressed interest income levels may be:

13A The level and trend of nonaccrual loans and other nonearning assets.

13B Ineffective asset pricing strategies.

13C Investment decisions.

13D Asset distribution.

13E Increasing competition.

14 If interest income levels are fluctuating severely, review IRRSA (FDIC) or other interest rate reports for possible interest rate risk exposure.

15 Review the common-sized balance sheet information (asset composition as a percent of total assets) in the UBPR for unusual shifts in balance sheet structure or unusual volumes of certain types of assets (excessive cash and due from) that may be influencing interest income.

16 Where earnings concerns derive from interest expense levels, determine the underlying cause for concern. Potential reasons for elevated interest expense may be:

16A Use of higher-cost borrowings.

16B Concentration of high-cost deposits.

16C Unfavorable migration of core deposits to higher yielding products.

16D Ineffective pricing practices.

16E Competition.

17 Determine those areas of overhead expenses significantly impairing the institution's earnings.

17A If salary expense appears excessive, review salary listings to determine the underlying source(s) of elevated expenses.

17B Review personnel benefits to determine if benefits are contributing to increased personnel expenses.

17C Determine if the bank properly reports employee benefits and does not pay for improper benefits.

17D Determine if the bank receives proper authorization for employee benefits from the board of directors.

17E Assess the reasonableness of incentive compensations.

17F Analyze efficiency of staffing levels relative to the organization's business lines and risk profile.

17G Determine if personnel cuts (downsizing) and occupancy expense reductions are negatively impacting the bank's ability to prudently supervise banking activities.

18 Determine appropriateness of fixed asset investments and lease payments.

19 Review service fees paid to affiliated parties and others for adequate documentation and appropriateness.

20 Review legal expenses for underlying causes of increased legal charges. The following situations are some possible reasons for elevated legal expenses:

20A Administration and disposal of problem assets.

20B Involvement in significant litigation.

20C Significant changes in the bank's strategic objectives (purchases, mergers, etc.).

21 Review the source or activity that is generating significant volumes of non-interest income and determine if the current volume is sustainable.

22 Determine management's rationale or motivation for increased reliance on non-interest income. Consider the strategic decisions that underlie the increased level of non-interest income. (If the bank is entering into a new type of service or business, determine if management prudently researched the risks and rewards of the new venture.)

23 When asset quality poses concerns, analyze the potential impact on operating profitability caused by:

23A Increasing levels of nonperforming assets.

23B Escalating administrative, legal, and collection expenses.

23C Additional Provisions for Loan Losses.

24 Identify which assets were sold and investigate management's rationale for selling the asset (excluding ORE), including the following possibilities:

24A Restructuring of loan or securities portfolio.

24B Attempting to bolster earnings by selling high-yielding assets.

24C Experiencing liquidity pressures.

25 Determine if the level of gains on sale of assets is a reliable source of recurring income.

26 Research large tax expenses to determine appropriateness. (Poor tax planning, timing of holding company tax payments.)

27 Review erratic tax levels to determine underlying reason for fluctuations. Significantly fluctuating tax liabilities may be indicative of:

27A Inaccurate financial reporting.

27B Inaccurate accounting for applicable taxes.

27C Poor tax planning.

27D A change in tax basis.

28 Consider independent verification of tax calculations, amount, and timing of required interim payments.

BOARD AND SENIOR MANAGEMENT SUPERVISION

29 Determine why previously identified deficiencies remain uncorrected.

30 Determine the reasons for poor compliance with policy guidelines, governing accounting standards, or applicable regulations.

31 Identify needed corrective actions and assess the adequacy and viability of management's commitments.

Earnings

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition. Impact Analysis also directs the examiner to consider possible supervisory options.

1 Analyze the impact of earnings deficiencies on the bank's overall condition. Estimate the future earnings levels and calculate their impact on capital and liquidity if these continue.

2 Determine the need for administrative or enforcement actions, formulate specific recommendations, and advise the appropriate supervisory officials on the nature of the concerns.

3 Discuss the possibility of administrative or enforcement actions with senior management and the board of directors.