

Financial *Alert*

Management & Compliance Solutions for Financial Institutions

April 2002



your state tax burden

by Joe O'Connell, Indianapolis

For much of the past decade, lower federal taxes have left states picking up the tab. The current economic environment will force many states to address revenue shortfalls by increasing tax revenue through new taxes, broader tax bases and increased tax rates.

Without proper attention, your financial institution's state tax bill could skyrocket, especially when conducting business across state lines. Proper strategic planning will help you control and even reduce your financial institution's state income tax liability.

Where to start

In general, if your effective state income tax rate is 4% or greater, you could save money. An in-depth analysis of your business operations, activities, organizational structure, financial statements and past tax returns usually reveals hidden opportunities to reduce state taxes. All types of taxes, including net worth, franchise and earned surplus taxes should be considered.

Conduct periodic nexus reviews, which assess your level of activity, to ensure you file properly in all the states you should and don't file in states where you shouldn't.

Not all activities create taxable nexus. State income tax statutes are not uniform with respect to sourcing of income, *e.g.*, interest, fees, etc. Therefore, many opportunities exist for strategies to reduce your overall state income tax burden.

Formulate a plan

A thorough study of your financial statements and business operations can help pinpoint where state income tax planning or restructuring can provide long-term savings.

Thorough research is the basis of a plan custom tailored to your financial institution. Assessing

ancillary costs, activities and consequences, as well as potential financial, tax and business issues, can cut your state tax rate and create immediate savings.

The right plan

Sometimes simple changes reap big rewards. Sometimes outright restructuring makes the most sense. Possible strategies to reduce your state tax liability include:

- ✓ Holding companies
- ✓ Investment subsidiary planning
- ✓ Operational modifications
- ✓ Alternative filing methods

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Security top bank technology concern

by Steve Nau, BKD Technologies, Springfield

When officers of approximately 9,000 financial institutions were asked about their biggest technology concern, the response was consistent: security.

This number-one concern was identified when BKD, through its alliance with Ininet Resources, surveyed all community financial institutions with assets under \$2 billion in the United States. This

survey was conducted with the Independent Community Bankers of America and is the second survey about trends in bank technology.

Concerns

Specific security concerns included risk of unauthorized access to bank information, privacy of customer data and fraud. These results mirror concerns voiced by regulatory agencies about the state of bank networks, especially banks connected to the Internet.

Concern over Internet banking ranked high, particularly functionality and customer usage compared to the high cost of these systems. Financial institutions also are dealing with integration issues and how to stay current with the competition.

Other concerns raised in the survey included technology costs, staying current, knowing what is available, trust in vendor advice and lack of training.

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- ✓ Get ready for the IT examiners



Making mergers & acquisitions work

by Rick Nisbeth, BKD Financial, Indianapolis

As the financial institutions industry continues to consolidate through mergers and acquisitions, the focus is shifting away from the advantages to shareholders of being acquired.

Now, the industry appears to be entering a period where institutions can create significant shareholder value by growing and acquiring.

Rampant acquisition activity started in the mid-1980s and peaked in 1994 and 1998 (see Chart 1). As banks were acquired, newly chartered banks stepped in to fill the community void at a brisk 3:4 pace, *i.e.*, for every four banks merged out of existence, three "de novo" banks started up.

The result is that today there are 9,821 financial institutions chartered in the United States. While the total number of financial institutions has decreased, it is a far cry from the predictions of "three thousand banks at the turn of the century."

The dynamics of the change provide insight and make a case for new opportunities to those that wish to grow and prosper through a simple, low-key acquisition program.

The opportunity

Acquisitions in recent years have consolidated the consolidators, *i.e.*, the traditional buyers of yesterday are gone, merged. Over the years, generations of buyers have gone through the cycle...buy banks, grow, buy banks and sell.

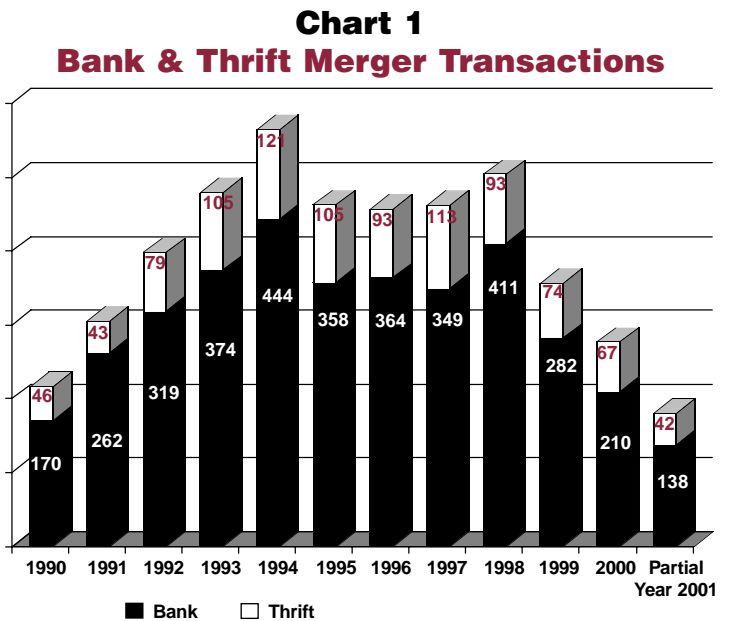
Currently there are 9,300 banks with assets under \$1 billion, compared to 13,900 in 1991. However, during the same time period, the number of banks with assets greater than \$10 billion has actually increased from 58 to 99. The banks that grew by acquiring other banks and thrifts have reached a point

where they become likely candidates for consolidation themselves.

So we are beginning to see a buyer's market and a lack of buyers. This void should and can be filled by certain aggressive and growth-minded financial institutions. Growth aimed at creating shareholder value is a laudable goal.

What's involved

Probably the most significant part of the equation is a publicly traded stock. Initially price, multiples and volume of trading are not the most important issues. High multiples and high volume are a significant advantage and, in time, both will come. But first, the



important piece is to have a currency that others believe in and provides liquidity.

Obviously, no real value can be created by transactions that result in significant or permanent dilu-

Reduce your state tax. . .

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- ✓ Income sourcing planning

Knowing which of these strategies to choose can be difficult. BKD can help you understand what will work best for your institution.

Take action

Once you choose the appropriate strategies and formulate a plan, how do you implement it? Whatever your strategy, your implementation process should address:

- ▲ Who will carry out each step of the plan
- ▲ When should each step be taken
- ▲ How to organize new entities
- ▲ What methods to use for franchise, income and other state tax filing
- ▲ Will there be regulatory implications

- ▲ Should any accounting procedures be changed

- ▲ Are management service contracts or new business licenses needed

Once your plan is in place, develop measurable objectives to track your success. If you monitor your progress and modify plans as needed, your financial institution should receive multiyear benefits in

the form of a reduced state tax burden.

BKD can help

Every time your company grows through acquisitions or new service lines your state tax posture changes. Contact your BKD Financial Institutions Group advisor for help in reducing your total state tax burden. □

BKD's SALT solutions

State and local taxes (SALT) can add significantly to your financial institution's operating costs. BKD's SALT solutions can help you reduce your tax liability and enhance the bottom line.

Our SALT solutions can help you remain compliant with state and local tax regulations while aiming to reduce your state and local tax burden through

refunds, credits and incentives.

Contact your BKD advisor for information on these SALT solutions:

- ▲ Sales and use tax
- ▲ Credits and incentives
- ▲ Employment taxes
- ▲ Property taxes
- ▲ Income and franchise taxes

for your institution

tion. So, in the initial years, prices paid will probably, by necessity, be lower, reflecting the lower multiples of a buyer's stock. But, to the extent sellers can be convinced that over the long run the paper they receive in a transaction is and will be worth more than the shares they are trading for it, they will be rewarded.

Thus, management and the board of the acquiring institution must be diligent and disciplined in both the selection and pricing of

each transaction. After the transactions, the new company must be diligent in realizing the economies and opportunities of the merger.

The rewards

Markets will reward earnings. Markets also will reward enhanced liquidity, more locations, growth and size. As depicted in Charts 2 and 3, the multiples accorded banks with higher and consistent earnings exceed, by a margin, the multiples realized by poor performers.

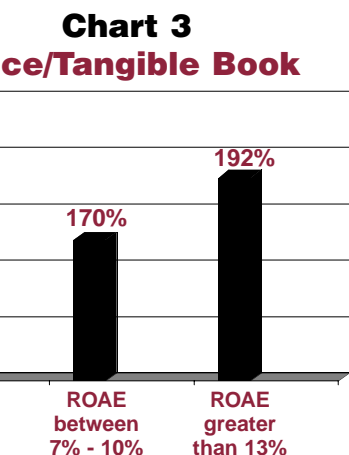
In addition, larger banks are accorded larger multiples, with those banks below \$100 million priced at 0.96 of tangible book value compared to 1.67 of tangible book value for those between \$1 and \$2 billion. Banks with five to 50 locations are priced higher than

banks with fewer than three locations. While not earth shattering, it's good to see that the markets are rational.

Where to begin

To take advantage of this opportunity to create shareholder value, begin with a strategy and a map. For example, an acquisition within a 15- to 25-mile radius makes more sense than one 300 miles away. Or the acquisition of an agricultural bank is a smart move in an agricultural community, particularly if the expertise acquired shores up deficiencies in your staff.

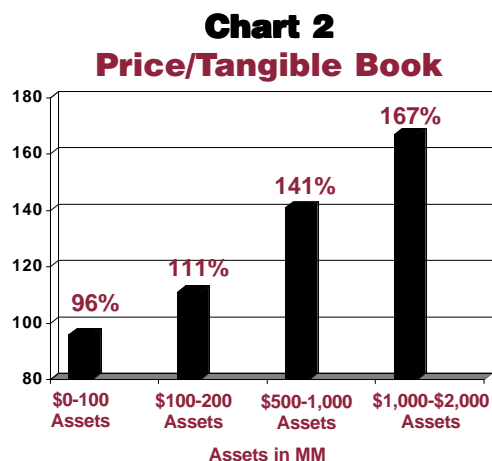
An acquisition should fit within the context of your strategic plan. It should take advantage of your strengths and/or strengthen your areas of weakness. When combined with a calling program by your



chair or president, opportunities to present proposals will arise.

The long-term success of your acquisition program will be determined by the message in your proposals. Consequently, the message should convince your target that the paper their shareholders will receive is superior, over the long run, to the paper they currently hold.

Contact your BKD Financial Institutions Group advisor for information on our corporate finance services, including financial institutions acquisitions. □



Security top bank technology. . .

(continued from page 1) New priorities

Both the current survey and the first, conducted in 1999, asked which of 17 applications banks currently had installed. A follow-up question asked which applications bank officers expected to evaluate in the short term.

In 1999, 27% of respondents had installed Internet banking and 54% intended to evaluate in the near future. The latest survey reveals 34% have installed Internet banking with 57% planning to evaluate.

These figures indicate that after loan document systems, Internet banking will be the most installed application on the list. Other top applications being

installed and considered are:

- ✓ Telephone banking
- ✓ Image check processing
- ✓ Report archival
- ✓ Deposit document preparation

E-mail on the rise

The application with the largest increase in implementation is e-mail. From 1999 to 2000, the percent of banks using e-mail rose from 61% to 79%. In the near future, e-mail will be the most implemented of all the specific applications surveyed.

Other changes include:

- ✓ The percentage of respondents planning to evaluate a change in core accounting systems dropped from 31% to 22%.

Results also indicate the continued consolidation of companies that provide core accounting systems.

- ✓ The percentage of banks reporting use of the Unix operating system increased from 13% to 39%. This despite the fact that only 6% of banks indicated their core accounting system runs using Unix.

Conclusions

Overall conclusions from the latest survey echoed those of 1999. Community banks continued to invest heavily in technology. Seventy percent felt they are on target with or ahead of their technology goals.



Almost all banks surveyed plan to continue significant investments in technology and to develop a written technology plan.

For a complete copy of the survey results or to discuss what the results mean to your financial institution, contact your BKD Financial Institutions Group advisor. □

Editor's Note - BKD, LLP is a founding member of Infnet Resources, an independent financial institutions network made up of regional accounting and consulting firms serving 1,300 financial institutions nationwide.

IT examiners are coming—are you ready?

by **Ryan Underwood, Little Rock, & Jerry Lowrance BKD Technologies, Springfield**

Is your institution's information secure? Are you ready for your next information technology (IT) examination?

New regulatory focus

Initial indications that financial institution regulators were increasing the emphasis on security came in early 2000. Enactment of the Gramm-Leach-Bliley Act and the events of September 11, 2001, seem to have intensified the focus even more.

When BKD met with Federal Deposit Insurance Corporation (FDIC) examiners in 2000 to discuss security, one point raised was that IT ratings would reflect a bank's IT status, as well as its security efforts.

At the time, financial institutions' ratings under the Uniform Rating System for Information Technology (URSIT) began to show a decline of one point over past ratings. In other words, a 1 rating often became a 2.

Following September 11, uniform ratings appear to be running two ratings lower than in the past. Today, it's not unusual to see a 1

rating fall to a 3. Though there still isn't much regulatory guidance available, IT examinations are taking a more in-depth look at traditional IT areas, as well as looking at many new areas.

Today's focus

IT regulatory examinations include:

- ▲ IT audit coverage
- ▲ Management oversight
- ▲ Policies, procedures and controls
- ▲ Risk assessments
- ▲ Strategic planning
- ▲ Data security
- ▲ Internet banking systems
- ▲ Automated clearing house and wire transfers
- ▲ Security of mainframe systems and local and wide area networks
- ▲ Voice response systems

What to do?

When addressing these concerns, remember the three objectives of security: confidentiality, integrity and availability. Security is more than just keeping information confidential. It's also making sure the information is complete, accu-

rate and available when needed.

Security risks to your institution's information are real. While the sensationalism and newsworthiness of security incidents has diminished, statistics compiled by the FBI, Computer Emergency Response Team (CERT) and other organizations show the number

and types of security breaches are rising at an alarming rate.

Your commitment to protecting valuable and sensitive customer data should not focus solely on placating

the examiners. Developing, implementing and maintaining sound security practices is simply good business.

If you don't believe your customer information is your bank's most valuable asset, just ask your customers. Just as you have vaults and alarms to protect their money, they expect you to have systems and controls to protect confidential information in your possession.

To provide the protection customers demand, think of security as a journey, not as a destination. Threats and risks to your information assets change almost daily. Your security practices must keep pace.

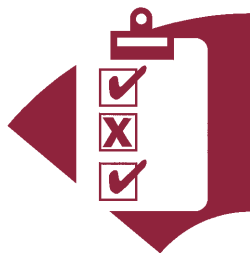
Implement an internal IT audit program equal to the sophistication of your systems. Your internal audit program also will require supplementation with an external review that may include:

- ▲ Local and wide area networks
- ▲ Internet banking systems
- ▲ Dedicated Internet connections
- ▲ Electronic banking systems
- ▲ Mainframe security settings

As regulatory examiners increase their scrutiny, a traditional electronic data processing (EDP) review utilizing the Federal Financial Institutions Examination Council (FFIEC) handbook may no longer be enough.

As with any security effort, the most important step here is to be **proactive**. In most instances, the examiners aren't going to tell you what you need to do. They're going to tell you what you're not doing. The result may be a lower uniform rating for IT.

Don't risk your rating. Contact your BKD Financial Institutions Group advisor for information on how BKD Technologies' experienced security consultants can evaluate your risks and help you improve your financial institution's security. □



**How to Reach
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