

Financial Alert

Management & Compliance Solutions for Financial Institutions

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Sarbanes-Oxley defines roles of audit committee & auditor

by Doug Van Meter, Enid

The appointment of the Public Company Accounting Oversight Board (PCAOB) members by the Securities and Exchange Commission (SEC), in consultation with the Secretary of the Treasury and the chair of the Federal Reserve Board, moves the *Sarbanes-Oxley Act of 2002* closer to implementation.

Audit committees, auditors, boards of directors and manage-

ment teams should carefully consider the Act's effect on conflict-of-interest issues and on the roles and responsibilities of audit committees and auditors.

Audit committees

The Act requires the members of audit committees, boards of directors or any other board committees to be independent.

They are not allowed to accept consulting, advisory or other compensatory fees from the companies

they serve other than those fees directly related to their board service. Further, they must not be an affiliate of the issuer or any of its subsidiaries.

Other responsibilities of audit committees:

- ▲ Pre-approval of all services (both audit and nonaudit services not specifically prohibited) provided to the company by the auditor

- ▲ Appointment of, compensation to and oversight of the work performed by any registered public accounting firm employed by the company

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State income tax planning a must

by Joe O'Connell, Indianapolis

Lower federal taxes for much of the past decade has left states to pick up the tab, despite recent efforts by state legislators to find better ways of addressing significant budget shortfalls.

Today's economic environment will force many states to address revenue shortfalls by increasing tax revenue through new taxes, broader tax bases and increased tax rates.

Your financial institution's state tax bill could skyrocket, especially if business is conducted across state lines. Proper strategic planning will help you control and even reduce your state income tax liability.

Where to start

If your effective state income tax rate is 4% or greater, there may be ways to decrease your tax liability. In-depth analysis of your business operations, activities, organizational structure, financial statements and past tax returns may reveal hidden opportunities to reduce state taxes, including net worth, franchise and earned surplus taxes.

Are you filing properly and in the correct states? Conduct periodic nexus reviews to assess your level of activity. Not all activities create taxable nexus, and state income tax statutes aren't uniform with respect to sourcing of income,

e.g., interest, fees, etc. Therefore, many opportunities exist to reduce your overall state income tax burden.

Formulate plan

Conduct thorough research to formulate a plan tailored to your financial institution.

Study your financial statements and business operations to pinpoint where state income tax planning or restructuring could help provide long-term savings.

It's possible to cut your state tax rate, and create immediate savings by assessing ancillary costs, activities and consequences, as well

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Evaluating mortgage

by **Kraig Ritter, Decatur**

Mortgage rates have recently reached 40-year lows, causing a massive refinancing wave that may result in impaired mortgage servicing rights (MSRs) for a number of institutions.

Because this impairment could have a significant impact on income, financial institutions that sell loans to the secondary market and retain servicing should review MSRs for proper accounting and valuation.

To better understand what caused the impairment, institutions should review the Statement of Financial Accounting Standards (SFAS) No. 140, which provides guidance for recognizing mortgage servicing rights as an asset and helps measure the impairment of the recorded asset.

Important concepts concerning SFAS 140:

- ▲ Applies to all institutions that originate or purchase mort-

gage loans and sell them while retaining the right to service the loans

- ▲ Financial institutions must recognize the right to service mortgage loans as separate assets recognized at the origination date based on the estimated fair value
- ▲ Mortgage servicing rights are amortized in proportion to and over the period of estimated net servicing revenue. Estimates of future servicing revenue should include expected late charges and other ancillary revenue. Estimates of future servicing costs should include direct costs for performing the servicing and an appropriate allocation of other costs
- ▲ Mortgage servicing assets must be evaluated for impairment. Impairment is recognized through a valuation allowance related to each individual stratum. The allowance can be adjusted to reflect upward moves in the fair value of the mortgage servicing rights, but recognition of fair value exceeding the amount of

originally capitalized mortgage servicing rights is prohibited

Determining fair value

The first step in determining fair value is to stratify the portfolio based on one or more of the predominant risk characteristics of the underlying loans: loan type; size; note rate; date of origination; term; location.

The stratified loan pools should initially be valued and measured for impairment on an individual basis.

Determining fair value of the mortgage servicing rights is subjective and can be measured in more than one way.

Use the amount for which an asset could be bought or sold in an arm's length transaction between willing parties to determine fair value of a mortgage servicing asset.

Quoted market prices in an

active market provide evidence of fair value and should be used as the basis for measuring servicing rights for both the initial capitalization and the subsequent evaluation for impairment.

An alternative is to employ a



recognized valuation technique using the following components to evaluate the fair value: estimated life of the underlying loan, prepayment rates, servicing costs and an appropriate discount rate to determine the present value.

Prepayment speed assumption (PSA)

The PSA, as highlighted by recent interest rate reductions, is the most significant and volatile component used to estimate the fair value of mortgage servicing rights.

Increases in PSA are the main factor in the recent decrease in the value of mortgage servicing rights.

The decline in long-term interest rates resulted in an increase in the projected rate at which loans serviced for others are expected to prepay, therefore shortening their expected average lives.

When the loan servicing rights were valued in the current environment with shorter lives, the assets had less value, and an impairment was identified.

PSAs can be obtained from

On a personal note...

Do you have a plan for managing your wealth?

- ✓ **Grow your assets: watch your money grow**
- ✓ **Preserve your assets: keep what you have**
- ✓ **Protect your assets: secure them now and in the future**

Growing, preserving and protecting wealth. These are the goals of WealthPlan, BKD's integrated approach to meeting the estate, financial planning, investment, insurance and tax

needs of individuals.

If BKD prepares your personal tax return, you are already taking advantage of a component of WealthPlan's integrated services.

Your BKD Financial Institutions Group advisor can introduce you to the WealthPlan advisors who help individuals with their wealth-management needs.

Our advisors have backgrounds in:

- ▲ Pension and benefit plans
 - ▲ Succession planning
 - ▲ Other financial specialties
- Next time you meet with your BKD Financial Institutions Group advisor, ask about WealthPlan services for individuals. WealthPlan solutions address personal financial needs from the advisor you already trust: BKD. □
- ▲ Tax law
 - ▲ Investments
 - ▲ Insurance
 - ▲ Estate planning



servicing rights

various sources: proprietary systems such as Bloomberg and rate shocking/option-adjusted spread models obtained from the various brokerage houses.

PSAs also vary depending on the specific market area. For example, institutions in Illinois could have a higher PSA than Arkansas because of circumstances specific to the Illinois real estate market.

Careful consideration should be given to the assumptions used to ensure the fair values are properly calculated in a consistent manner from period to period.

Amortization

Mortgage servicing rights are amortized in proportion to and over the period of estimated net servicing revenue, but what is the proper amortization method?

Acceptable methods include amortization based on the straight-line or sum-of-the-years'-digits method, a method that more quickly accelerates the amortization than the straight-line method. The net value of the mortgage servicing rights will be compared to the current fair value to determine any impairment.

Impairment

Determine the timing of the impairment analysis. The more significant the mortgage servicing right asset is to a company, the more frequently the mortgage servicing right analysis should be performed.

Smaller portfolios may initially require annual analysis until the asset begins to grow. Analysis of larger portfolios may be required quarterly depending on reporting requirements or even monthly to properly assess impairment.

The impairment analysis to determine fair value follows the same methodology as the initial recognition.

How BKD can help

Mortgage servicing rights can have a significant and volatile impact on an institution's income statement.

Governing bodies are expecting impairments of mortgage servicing rights because of recent decreases in interest rates. Therefore, it is important for all institutions to carefully value their mort-

gage servicing rights to determine impairment.

Financial institutions with significant MSR's should:

- ▲ Consider obtaining a valuation of the MSR before December 31, 2002
- ▲ Consider annual valuations thereafter, say December 31 of each year for calendar year-end institutions
- ▲ Monitor the prepayment speeds

each quarter, and consider an interim valuation should the market so warrant

- ▲ Use an accelerated amortization method, such as sum of the year's digits over a five- to seven-year life

Your BKD Financial Institutions Group advisor is available to guide you through the complexities of accounting for SFAS No. 147 on mortgage servicing rights. □

FAS 147 changes rules for certain financial institution acquisitions

by Lou Matusiak, Indianapolis

 In October 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 147, *Acquisition of Certain Financial Institutions*.

The primary purpose of this standard is to remove the applicability of SFAS No. 72 from the acquisition of all or part of a financial institution. Acquisition of part of a financial institution is often referred to as a branch acquisition.

Statement 72 will continue to apply to transactions involving two or more mutual enterprises, pending conclusion of the board's project on accounting for such transactions.

Statement 72 involves the acquisition of a troubled financial institution, *i.e.*, one with liabilities exceeding identified tangible and intangible assets, issued when interest rates were at record high levels.

For many transactions, the discount on the loans was often substantial and was accreted to income. The level-yield method was used for a relatively short period because of estimates of refinancings and prepayments. The goodwill that arose was amortized for a

longer period using the straight-line method.

Statement 72 requires goodwill arising from these transactions be amortized for the same period using the same method as the discount recognized on long-lived, interest-earning assets.

SFAS No. 142, *Intangible Assets*, applies to goodwill arising from Statement 72 transactions. The board indicated many branch acquisitions also should be justified under Statement 72 if they were acquired in a net-settled transaction with liabilities exceeding identifiable tangible and intangible assets.

Consider a branch with \$50 million in deposits and fixed assets with a fair value of \$2 million. Let's assume it was acquired with a premium paid equal to 6% of the deposits. The acquirer would receive a check for \$45 million.

If a deposit intangible study is not performed (often the case for pre-142 transactions), goodwill of \$3 million would be recorded, and the transaction would be considered subject to the requirements of Statement 72.

With the adoption of SFAS 147, all goodwill will be subject to the provisions of SFAS 142, **as long as it arises in a business combination**.

For guidance in determining if an acquired asset group constitutes a business, the standard suggests a review of Emerging Issues Task Force (EITF) Issue No. 98-3, "Determining Whether a Non-monetary Transaction Involves Receipt of Productive Assets or of a Business."

Paragraph A11 states, "The Board observed that determining whether the transferred net assets and activities constitute a business under Issue 98-3 requires analysis of all facts and circumstances and the exercise of professional judgement."

Paragraph A9 states, "...some Board members expressed their belief that for those (branch) acquisitions, proper application of the provision of Statement 141 will often result in a relatively small amount of goodwill."

For all future transactions, the guidance is clear. For past transactions, paragraph 8 states goodwill should continue to be amortized "unless the transaction in which that asset arose was a business combination."

SFAS No. 147 is effective for all transactions occurring on or after October 1, 2002, with earlier application encouraged.

For further information, contact your BKD Financial Institutions Group advisor. □

Sarbanes-Oxley Act. . .

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- ▲ Ensure the public accounting firm reports directly to the company's audit committee
- ▲ Establish procedures for receiving and addressing complaints about the company's accounting practices, including internal controls and employee concerns about questionable accounting practices
- ▲ Authority to retain and compensate independent counsel and other advisors to execute the audit committee's duties

Auditors

Auditors, like audit committee members, must maintain their independence and are specifically prohibited from providing the following nonaudit services to public companies:

- ▲ Bookkeeping
- ▲ Information systems design and implementation
- ▲ Appraisals or valuation services
- ▲ Actuarial services
- ▲ Internal audits
- ▲ Management and human resources services
- ▲ Broker/dealer and investment banking services
- ▲ Legal or expert services unrelated to audit services

In addition, the PCAOB may determine other nonaudit services to be impermissible by rule. Other nonaudit services not prohibited are allowed if pre-approved by the audit committee.

Additional provisions of the Act require auditors to deliver certain communications to audit committees:

- ▲ Every critical accounting policy and practice to be used
- ▲ Every alternative treatment of financial information in GAAP, ramifications of each alternative and auditor's preferred treatment
- ▲ Other material communica-

tions between the auditor and management, including the management letter and passed adjustment schedules

The Act also requires the lead audit partner and audit review be rotated every five years on public company engagements.

Another provision stipulates that accounting firms are ineligible to provide audit services to a public company if one of the company's current executive officers (chief executive officer, controller, chief financial officer, chief accounting officer, etc.) was employed by the accounting firm and worked on the company's audit the previous year.

Insider lending

One provision of the Act specific to financial institutions concerns insider lending.

Public companies or their subsidiaries are prohibited from ex-

tending credit to a director or executive officer of the company in the form of a personal loan unless the loan is subject to and is being implemented according to Regulation O as promulgated by the Fed.



There are a few exceptions, and insider lending rules don't apply if the loan was made before July 30, 2002, and has not been renewed.

Manufactured home and home improvement loans, consumer loans and loans under open-end credit plans are exempt if made in the ordinary course of business and are of credit quality made under normal lending practices with terms and conditions offered to the general public.

Keeping you informed

At this time, only public companies are subject to the Act, though regulations and guidance are under review to determine whether modifications should be made that would include a specific group of or all financial institutions.

* * *

We continue to monitor requirements affecting financial institutions. Contact your BKD Financial Institutions Group advisor for more information. □

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Managing the liquidity landslide

by Ryan Hayhurst, vice president of the Financial Strategic Group at James Baker & Associates, Oklahoma City

The Federal Reserve Board (Fed) began to cut interest rates in January 2001. Since then, the Fed Funds rate fell 575 basis points (BPs) to a 40-year low of 1.25%.

As a result, an unexpectedly large amount of cash flow came from both loan and investment portfolios, creating a "liquidity landslide" for community financial institutions.

Most of the excess cash flow came from increases to three main sources:

- ▲ Mortgage loan refinancing
- ▲ Prepayment cash flow from mortgage-backed securities (MBSs) and collateralized mortgage obligations (CMOs)
- ▲ Calling in callable securities

The three-year bear market in stocks, and the negative press surrounding many Wall Street firms compounded the problem but generated significant deposit growth, and a weak economic environment reduced loan demand in all but a few hot spots.

When combined, these events created a massive liquidity build up that financial institutions needed to invest. Faced with investment yields at 40-year lows, many institutions decided to wait, building large positions of federal funds in anticipation of higher, more attractive investment yields in the future.

Because yields have failed to rise, with the Fed's most recent 50BP rate cut bringing the funds rate to 1.25%, financial institutions should ask themselves this simple question: What is the opportunity cost of waiting to invest?

Table 1
Federal Funds Rate Scenario Comparison

	Unchanged	+150 Basis Points	+300 Basis Points
December '02	1.25	1.25	1.25
January '03	1.25	1.38	.50
February	1.25	1.50	1.75
March	1.25	1.63	2.00
April	1.25	1.75	2.25
May	1.25	1.88	2.50
June	1.25	2.00	2.75
July	1.25	2.13	3.00
August	1.25	2.25	3.25
September	1.25	2.38	3.50
October	1.25	2.50	3.75
November	1.25	2.63	4.00
December	1.25	2.75	4.25
Average	1.25	2.00	2.75

Table 2
**Average Yield & Income Pickup
for \$10,000,000 Fed Funds**

	Unchanged	+150 Basis Points	+300 Basis Points
Average Yield of Fed Funds	1.25%	2.00%	2.75%
Yield Spread@3.0%	175 BP	100 BP	25 BP
Yield Spread@3.5%	225 BP	150 BP	75 BP
Yield Spread@4.0%	275 BP	200 BP	125 BP
Income Pickup@3.0%	\$175,000	\$100,000	\$25,000
Income Pickup@3.5%	\$225,000	\$150,000	\$75,000
Income Pickup@4.0%	\$275,000	\$200,000	\$125,000

For comparison, the three scenarios in Table 1 could describe where the Fed Funds rate is next year:

- ▲ Scenario 1 assumes the Fed leaves rates unchanged for all of 2003
- ▲ Scenario 2 assumes rates ascend 150 basis points over the year, resulting in an average rate of 2.00% for 2003
- ▲ Scenario 3 assumes a more aggressive Fed will hike rates 25BP a month to finish the year at a 4.25% Fed Funds rate, though this 300BP tightening cycle would yield an average rate of just 2.75%

substantially less than what conservative, low-duration investment securities would yield.

Depending on the type of bond chosen, financial institutions could earn between 3.0% and 4.0% by investing in securities with an effective duration less than 3.0 (duration measures the percentage change in value given a 1% change in rates and lower duration bonds have less price volatility).

Table 2 above represents the average yield and income pickup for a \$10 million Fed Funds' position if the funds could be reinvested in an investment earning 3.0%,

"Because of ever-tightening margins, many institutions could invest Fed Funds in conservative, low-duration bonds and increase earnings significantly without materially increasing interest-rate risk."

If the first scenario seems unlikely, recent history suggests the Fed might hold rates steady for an extended period after completing an easing cycle.

For 17 months between 1992 and 1994, rates held at 3%, ascending and holding at 5.25% for 14 months between 1996 and 1997. This was followed in 1997 and 1998 by 17 months at 5.50%, finally holding at 1.75% for 11 months in 2002.

All three scenarios would earn

3.5% or 4.0%. Even with rates +300BP, reinvesting those funds today would result in earnings between \$25,000 and \$125,000 higher.

Choosing the best structure is critical because rising rates lead to depreciation of the investments. Focus special attention on buying bonds that provide a good yield, but also have limited cash-flow extension and limited depreciation risk. Some bonds perform better

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Managing the liquidity. . .

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than others in rising rate environments, and would be the favored investments to replace Fed Funds in today's market.

Today, community financial institutions face an unprecedented liquidity buildup at a 40-year low in interest rates. The cost of keeping money invested in Fed Funds and

other short-term investments continues to rise as the Fed maintains accommodative monetary policies.

Because of ever-tightening margins, many institutions could invest Fed Funds in conservative, low-duration bonds and increase earnings significantly without materially increasing interest-rate risk. □



State tax planning. . .

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as potential financial, tax and business issues.

Properly implemented, a strategic plan can provide an annuity of savings.

The right plan

Simple changes can reap big rewards. Sometimes, complete restructuring makes the most sense. Strategies to help reduce your state tax liability:

- ▲ Holding companies

- ▲ Investment subsidiary planning
- ▲ Operational modifications
- ▲ Alternative filing methods
- ▲ Income-sourcing planning

Take action

Whatever strategy you choose, the implementation process should address:

- ▲ Who will execute each step of the plan
- ▲ When should each step be taken

- ▲ How to organize new entities

- ▲ What methods are best 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

When your plan is in place, develop measurable objectives to

track your success. Monitoring progress and modifying your plan as needed may help your institution to achieve reduced state tax burdens as multiyear benefits.

BKD can help

Your state tax posture changes every time your company grows through acquisition or new service lines.

Contact your BKD Financial Institutions Group advisor for help reducing your total state tax burden. □



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