

Financial Alert

Management & Compliance Solutions for Financial Institutions

August 2003

Increased M&A activity projected nationwide

by Pat Hayes, BKD Financial, LLC

Financial institution and thrift merger activity dropped 42% from 1999 to 2002, but things are beginning to look up for mergers and acquisitions (M&A).

Thanks to 2003's fairly robust first five months, an almost 4% increase in transactions is projected nationwide for 2002 to 2003.

However, activity in the BKD service area isn't expected to see the same increase in 2003 and may continue to trend downward.

Compared to a high of 164 transactions in 1999, the states where BKD offices are located

(Arkansas, Colorado, Illinois, Indiana, Kansas, Kentucky, Missouri, Nebraska, Ohio, Oklahoma, Texas) saw only 87 transactions in 2002, with 77 expected for 2003.



While there are fewer overall transactions than in years past, the multiples being paid are beginning to trend upwards.

After reaching a low of 1.67 times tangible equity in 2001 and only a marginal increase in 2002, the transactions in 2003 have had a median price/tangible equity of almost 1.90 nationwide.

BKD's service area also is

enjoying an increase in the multiple of tangible equity, rising from 1.43 times in 2002 to 1.63 in 2003.

Over the past few years, the multiple of the last 12 months' (LTM) net income has been constant.

The median price to LTM net income has been approximately 17 times for the past three years, which, for the BKD service area, is actually higher than the multiple of earnings paid in 1999.

Several other factors have greatly influenced the M&A market in past years. In addition to the general economic slowdown, new compliance issues have weighed heavily on the minds of most executives and boards of directors.

As the new compliance rules are better understood, many observers predict M&A activity will begin to pick up.

The new regulations will affect the due diligence process as well because prospective buyers may want to complete a thorough exam of the selling financial institution's compliance program.

There also may be fewer transactions than those occurring between 1998 and 2000 simply because fewer institutions are available today.

When the economy begins and continues to rebound, and as new compliance rules become more familiar, activity should pick up and resume a more reasonable pace. □

JGTRRA offers relief to financial institutions & shareholders

by Ryan Underwood, Little Rock

On May 28, President Bush signed into law the *Jobs and Growth Tax Relief Reconciliation Act of 2003*. The Act contains significant tax cuts for financial institutions and their shareholders. Following is a summary of selected provisions.

Reduced capital gains rates

This provision applies to sales,

Tax tip: Planning becomes critical when offsetting short-term capital gains and/or to using \$3,000 of net long-term capital losses to offset ordinary income.

exchanges and payments received on or after May 6, 2003, and before January 1, 2009. It reduces the 10% and 20% rates on net capital gains to 5% (zero in 2008) and 15%, respectively.

The lower rates apply to both

the regular and the alternative minimum tax (AMT) and are only available on sales of assets held more than one year.

Dividend tax relief for individuals

This provision applies to dividends received in tax years beginning after 2002 and before 2009.

Under the Act, the dividends an individual shareholder receives from domestic and qualified for-

(continued on page 2)

In this issue

- ✓ Increased M&A activity projected nationwide
- ✓ JGTRRA offers relief to financial institutions & shareholders
- ✓ CRA mutual funds come of age
- ✓ SEC implements Sarbanes-Oxley internal control provisions



JGTRRA offers relief. . .

(continued from page 1)

eight corporations are generally taxed at the same rate as capital gains.

The same treatment applies to both the regular and the AMT. As a result, dividends will be taxed at rates of 5% (zero in 2008) and 15%.

Dividend income that doesn't qualify for the lower tax rates include:

- ▲ Dividends on stock that hasn't been held more than 60 days during a 120-day period and at least 60 days before the ex-dividend date (longer for preferred stocks)
- ▲ Dividends from corporations exempt from tax under Section 501 (charitable, religious, scientific, etc.) or Section 521 (farmers' cooperatives)
- ▲ Amounts allowed as a deduction under Section 591 (deduction for dividends paid by mutual savings banks)
- ▲ Dividends paid on employer securities held by an employee stock ownership plan

Special rules also limit dividends received from a regulated investment company or real estate investment trust.

S-corporation institutions should consider paying a dividend out of earnings and profits that may have been trapped in the institution when the S-corporation election was made.

Tax tip: Financial institutions that are C corporations should analyze the cost vs. benefit of making special dividend payments. Special dividend payments could be used to eliminate accumulated earnings tax problems or to distribute excess capital.

Remember, regulatory approval may be required for dividend payments that exceed certain thresholds.

Identity theft: prevention is key

Identity theft is the fastest growing financial crime in the United States. In one high-profile case, the criminals made off with \$2.7 million by pilfering more than 30,000 passwords used by financial institutions and reselling them for \$30 each to a gang of 20 identity thieves in New York.

Using credit report information, the group took over a number of consumer checking accounts, obtained credit cards and opened brokerage accounts in the consumers' names.

The crime was exposed when the financial institutions whose customers were victims of the identity theft noticed they were being billed for credit

reports they never requested.

Despite the rapid deployment of fraud detection software at financial institutions, experts predict annual losses from identity theft will reach \$1 billion.

It's important for financial institutions to be aware of the enormity of identity theft and know how to prevent it.

BKD's Forensics & Dispute Consulting services and BKD Technologies divisions can help your financial institution detect and prevent fraud and implement protective practices and procedures.

Contact your BKD Financial Institutions advisor for more information. □

Regular income tax rates reduced

The provision is effective for tax years beginning after December 31, 2002, and accelerates the reductions in regular income tax rates scheduled for 2004 and 2006.

Thus, for 2003 and later years, regular income tax rates that exceed 15% are reduced to 25%, 28%, 33% and 35% (from 27%, 30%, 35% and 38.6%).

Increased deductions under Section 179

For property placed in service in tax years beginning in 2003, 2004 and 2005, the Act provides \$100,000 as the maximum dollar amount that may be deducted under Section 179.

Qualifying property is generally tangible personal property used in the active conduct of a trade or business. For 2003, 2004 and 2005, qualifying property also includes off-the-shelf computer software.

In addition, the \$200,000 phase-out amount is increased to \$400,000 for the same period. The dollar limitations are indexed annually for inflation for tax years beginning after 2003 and before 2006.

The provision is effective for taxable years beginning after December 31, 2002.

Special depreciation allowances

Under the Act, an additional first-year depreciation deduction is allowed equal to 50% of the adjusted basis of qualified property.

Qualified property is defined in the same manner as the 30% additional first-year depreciation deduction but with modifications to the applicable time period for acquisition (or self-construction) of the property.

Qualified property must meet certain requirements:

▲ It must be one of the following:

- ✓ Property for which the rules of Section 168 of the Modified Accelerated Cost Recovery System (MACRS) apply, with a recovery period of 20 years or less, *i.e.*, property included in the 3-, 5-, 7-, 10-, 15- and 20-year MACRS classes
- ✓ Qualified leasehold improvement property, *i.e.*, certain interior improvements to nonresidential buildings leased between unrelated individuals

▲ Original property use must begin with the taxpayer, *i.e.*, new property

▲ Acquired after May 5, 2003, and before January 1, 2005

▲ Placed into service before January 1, 2005

The provision is effective for tax years ending after May 5, 2003. Property doesn't qualify if a binding written contract for the acquisition was in effect before May 6, 2003.

Property for which the 50% additional first-year depreciation deduction is claimed is not eligible for the 30% additional first-year depreciation deduction.

Corporate estimated taxes

The Act provides that 25% of any required installment of corporate estimated tax, otherwise due in September 2003, will not be due until October 1, 2003.

For example, a calendar year corporation's payment on its third installment of an estimated tax of \$1,000,000 is due September 15, 2003. The Act requires \$750,000 to be paid on September 15, 2003, with the remaining \$250,000 to be paid October 1, 2003.

Contact your BKD Financial Institutions Group advisor for more information about how JGTRRA provisions apply to your financial institution and your shareholders. □

CRA mutual funds come of age



by David Sand, CEO/CIO, Access Capital Strategies Community Investment Fund, Inc.

The first mutual fund of the *Community Reinvestment Act* (CRA) of 1977 passed the five-year mark this June.

The Access Capital Strategies Community Investment Fund was launched when the investment test portion of the Act initiated full-scale operations.

The fund has spread to 32 states, has more than 80 investors and has passed \$250 million in assets. In March 2001, Merrill Lynch Investment Managers became the fund's subadvisor.

The Access Fund and a similar CRA funding vehicle, the Qualified Fund, operate on a few simple premises.

While some are unique to the demands of CRA, most are based on fundamental financial practices, such as diversification, professional management and asset allocation.

Investing through an institutional mutual fund allows financial institutions to target investments to specific geographic areas, which helps them satisfy the CRA's investment test mandate to invest in one's assessment area.

This also encourages financial diversification because returns are based on a portfolio composed of similar assets from other investors' targeted areas.

While community economic development can be supported through a wide variety of investments, the fund, like CRA, is primarily channeled into housing, both affordable home ownership and rental housing.

Investments must be of agency or AAA credit quality, creating a credit hurdle for the fund and requiring credit enhancement for all investments.

FannieMae and FreddieMac are both committed to expanding the frontiers for affordable housing, and FannieMae is an investor in Access Capital Strategies, LLC, the fund's manager.

The fund works closely with FannieMae to identify cutting-edge investment opportunities in different regions that represent housing-related economic development.

Investors receive a quarterly dividend, financial reports and other financial investment information. They also receive investor-specific reports on CRA-related aspects of investments made on their behalf in their targeted areas.

Regulators from each federal banking agency have given investors credit for fund investments. From April 1, 2002, to March 31, 2003, the fund had a dividend yield to investors of 6.2%.

For the three-year period ending May 31, 2003, the fund's annualized total return was 9.5%; from its June 1998 inception to May 31, 2003, the fund's annualized total return was 6.75%.

Challenges to financial institutions must be met from every aspect of business; meeting CRA requirements is rarely at the top of the list.

An institution may be able to use CRA mutual funds to meet a

What's CRA?

Editor's note: The following was retrieved July 29, 2003, from <http://www.occ.treas.gov/crainfo.htm>.

The CRA was enacted in 1977 to prevent redlining and to encourage banks and thrifts to help meet the credit needs of all segments of their communities, including low- and moderate-income neighborhoods. It extends and clarifies the long-standing expectation that banks will serve the convenience and needs of their local communities.

The CRA and its implementing regulations require federal financial institution regulators to assess the record of each bank and thrift in helping to fulfill their obligations to the community and to consider that record in evaluating applications for charters or for approval of bank mergers, acquisitions and branch openings.

The federal financial institution regulators include: OCC;

Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision.

The law provides a framework for depository institutions and community organizations to work together to promote the availability of credit and other banking services to underserved communities.

Under its impetus, banks and thrifts have opened new branches, provided expanded services, adopted more flexible credit underwriting standards, and made substantial commitments to state and local governments or community development organizations to increase lending to underserved segments of local economies and populations.

CRA applies to federally insured depository institutions, national banks, thrifts and state-chartered commercial and savings banks.

For more information about CRA, visit the OCC web site at <http://www.occ.treas.gov> □

portion of its investment test needs, making life a little easier for compliance officers and investment staff. However, each investment in the fund must be analyzed to determine what portion can be specifically allocated to the CRA investment test.

Contact your BKD Financial Institutions Group advisor for more information about CRA's Access Capital Strategies Community Investment Fund.
* * *

Editor's note: According to representatives of Access Capital Strategies Community Investment Fund,

Inc., Cambridge, Massachusetts, the fund is a private placement offered only to qualified investors. Past performance is no indication of future results.

This information is not an offer of the fund, and is not a complete description of the fund and the risks associated with an investment.

The offering of the fund can only be made through the current version of the fund's Private Offering Memorandum, which fully describes the Fund, including investment strategies, risk factors, charges and expenses. □

Check out. . .
Financial Alert



SEC implements Sarbanes-Oxley internal control provisions

by Jim Morris & Steve Moore,
Indianapolis

The Securities and Exchange Commission (SEC) recently approved rules and developed guidelines to implement the internal control provisions under Section 404 of the *Sarbanes-Oxley Act of 2002* (the Act).

In its rulemaking, the SEC also established key dates for implementing these provisions.

In short, "accelerated filers" will be required to comply with the rules about management's report on internal controls for fiscal years ending on or after June 15, 2004.

All other issuers will be required to comply for their fiscal years ending on or after April 15, 2005.

Following is more detail about these provisions as released by the SEC May 27.

Management's responsibilities

Section 404 of the Act directed the SEC to adopt rules requiring an annual internal control report of a company, other than a registered investment company. The report must contain:

- ▲ A statement of management's

responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting

- ▲ Management's assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the internal control structure and procedures for financial reporting

The new rules implementing Section 404 define the term "internal control over financial reporting."

In addition, under the SEC's final rules, management's annual internal control report also must contain the following:

- ▲ A statement identifying the framework used by management to evaluate the effectiveness of this internal control
- ▲ A statement that its auditor has issued an attestation report on management's assessment

The auditor's report must comply with the standards established by the Public Company Accounting Oversight Board. Those standards have not yet been finalized.

Under the new rules, manage-

ment must disclose any material weakness and will be unable to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in such control.

Furthermore, the framework on which management's evaluation is based will have to be a suitable, recognized control framework established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.

Implementing new rules

The new rules implementing Section 404 define the term "internal control over financial reporting."

The term means a process designed or supervised by the registrant's principal executive and financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance about the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (GAAP).

In addition, internal control over financial reporting should include policies and procedures that:

- ▲ Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant
- ▲ Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant
- ▲ Provide reasonable assurance about prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements

The SEC also voted to adopt amendments requiring companies to perform quarterly evaluations of changes within the company that have materially affected or are reasonably likely to materially affect the company's internal control over financial reporting.

* * *

BKD Financial Institutions Group can help you interpret the provisions of the Act and help advise on implementation strategies. For further guidance, contact your BKD advisor. □

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