Financial Alert

Management & Compliance Solutions for Financial Institutions

January 2004

Check 21 finally becomes law

by Gary Farrar, BKD Technologies

On October 28, 2003, President Bush signed the *Check Clearing in the Twenty-First Century Act* (Check 21) and brought years of dreaming about a checkless payment system a little closer to reality.

Check 21 won't eliminate checks, but it will dramatically reduce the payment system's volume of paper checks.

Many believe Check 21 will produce the most significant financial payment system changes in the last 50 years. It will have an impact on all financial institutions, and, with an effective date of late 2004, you will have to move quickly to implement compliance plans.

> **. . .with an effective due date of late 2004, you will have to move quickly to implement compliance plans.**

It's estimated the current check payment system costs the U.S. economy approximately $120 billion per year, which, by comparison, is equal to one-quarter of the annual Social Security budget and one-third of annual new car sales in America.

Even though the total volume of checks written in the U.S. has declined by up to 3% per year since the mid-1990s, no one predicts significant reductions in the fixed costs associated with the current payment system.

In recent years, small groups of financial institutions have attempted to voluntarily "electronify" the system with mixed results. Now, Check 21 mandates fundamental changes in the system to make it more efficient.

Using electronic images & IRDs

Basically, the goal of Check 21 is to eliminate the movement and handling of paper checks by allowing institutions to either present paying institutions with a check's electronic image or use "substitute checks," also known as image replacement documents (IRDs).

Electronic images and IRDs are considered the legal equivalent of actual paper checks. This allows the collecting institution to truncate checks, as well as the associated processing costs.

The law requires *all* paying institutions to accept IRDs for payment, but it does not require them to accept electronic images.

Financial institutions that wish to exchange electronic images must establish agreements to do so that address image quality, return procedures, etc.

Implications

Much of Check 21's impact will affect your back-office operations, though customers also will be affected.

For example, it will become more difficult for customers to "play the float" that exists in the current payment system.

Though it may become impractical and expensive to return paper checks and IRDs in customer statements, it may be possible to provide customers online access to their checks' images.

(continued on page 3)

In this issue

Community banks shift focus from acquiring to managing existing technologies

3rd annual ***Community Bank Technology Survey*** *results*

by Don Hutson, St. Louis

Sixty-six percent of community banks cited affordability and security as their top technology concerns, according to the third annual **Community Bank Technology Survey** conducted by the Independent Community Banks of America (ICBA) and InFinet Resources.

In previous years, community bankers indicated greater interest in finding new technologies to stay competitive. Today, bankers are looking to enhance the effectiveness of existing technologies, adding only those most likely to contribute to the bottom line.

The survey is the most comprehensive technology survey by and for community banks and was completed by more than 1,000

(continued on page 2)

BKD LLP

Tax savings imbedded in real estate

by Sarah Wurl, St. Louis

Your real estate holdings represent a major capital investment. A real estate cost-segregation study can help accelerate income tax depreciation deductions and generate significant cash-flow savings.

Instead of waiting years to see a return on real estate investments, a real estate cost-segregation study could help you recover major capital improvement costs more rapidly.

Cost segregation is a procedure for identifying and reclassifying capitalized amounts allocable to tangible personal property, other tangible property, *i.e.*, Internal Revenue Code Section 1245 and 1250 property and land improvements from building costs, which typically depreciate over 39 years.

Imbedded tax savings

Real estate cost segregation generates cash tax savings by identifying shorter-lived assets that qualify for five-, seven- or 15-year write-off periods.

A complete audit trail traces derived unit costs from contract documents and other source data. Your property is reclassified into shorter-life classes based on applicable tax authorities.

Our cost-segregation consultants work with thousands of different businesses to help identify tax savings from:

- New buildings presently under construction
- Existing buildings undergoing renovation, remodeling, restoration or expansion
- Purchases of existing properties
- Office/facility leasehold improvements and "fit outs"
- Post-1986 real estate construction, building acquisitions or improvements where no cost-segregation study was performed (even though the statute of limitations previously closed on the property construction/acquisition year)

Earlier acquisitions can qualify

If you constructed or purchased real estate in an earlier year but did not take advantage of a cost-segregation study, you may still have an opportunity to realize tax savings.

Under current Internal Revenue Service (IRS) rules, you now can prospectively deduct in one year the depreciation amounts you were legally entitled to but did not claim because of erroneous property classifications.

This opportunity is available even though the statute of limitations previously closed on the property construction or acquisition year.

The cost-segregation team you use should have the engineering and appraisal skills to help identify the overlooked shorter-life assets and file the necessary IRS paperwork to recover your tax deductions.

Engineering approach

The engineering-based approach BKD uses is the only cost-segregation method accepted by the IRS for acquired properties. It's also the best method for improving cost segregation returns on new construction.

Our consultants perform and provide the following during a cost-segregation study:

- Physically inspect the property
- Examine architectural and engineering drawings and specifications for potential asset reclassification
- Analyze cost data, including the contractor's application of payments, change orders, owner-incurred costs and indirect disbursements

Community banks shift focus from. . .

(continued from page 1)

community bank executives nationwide.

Highlights from the survey include:

- Imaging technology continued to gain ground in 2003 as bankers sought the efficiencies of electronic images vs. paper. Community banks already using check-imaging applications climbed to 53%, from 47% in 2002. Another 39% of community banks indicated plans to evaluate the technology in the next 12 to 18 months.
- In 2002, 54% of community banks had web sites offering Internet banking. Although Internet banking is still a concern, 81% of banks with more than $100 million in assets offer customers the technology, as opposed to 38% of banks with assets of less than $100 million.
- Customer Relationship Management (CRM) software lost some of its steam from a year ago. The survey said 36% of banks plan to evaluate using CRM in the next 12 to 18 months, down from 43% last year.
- Community banks, both large and small, continue to be tempted by the cost-saving potential of e-mail statement delivery with 52% of the respondents planning to evaluate it within the next 12 to 18 months.
- Imaging-related technologies and Internet banking are still on the minds of community bankers who completed the annual technology survey. Talking and Internet-enabled automated teller machines still generate little interest to respondents, as do other technologies less likely to offer a measurable return on investment.

Community banks, while they continue to commit substantial resources to technology, are increasing their focus on security, efficiency and the return on technology investments.

For complete survey results, visit BKD's web site at **www.bkd.com** and click on **Bank Technology Survey** or contact your BKD Financial Institutions Group advisor for a copy.❑

Check out. . .

Financial Alert @ bkd.com

cost-segregation studies

- Prepare an itemized list of property units qualifying for shorter-life classification
- Apportion direct labor, material components and indirect costs based on engineering drawings and specifications
- Reconcile total costs per the engineering analysis to capitalized project costs
- Full documentation using engineering and cost-estimating procedures recognized by the courts and the IRS

Payback from your investment

A cost-segregation study could help your financial institution receive a present value cash-flow savings equalling 10 or more times the cost of its investment.

Other benefits include:

Property tax relief – There may be excludable costs in your institution's tax base that may be exempt in certain jurisdictions, *e.g.*, overtime hours, building demolition costs and select change orders.

Bonus depreciation – The *Job Creation and Worker Assistance Act of 2002* provides a temporary depreciation bonus to businesses for the purchase of new property. To increase overall tax savings, this extra first-year depreciation deduction should be coordinated with the additional depreciation deduction bonus offered by the 2003 Act.

Other credits and incentives – Many states provide special tax credits, incentives or abatements for new construction.

Cost segregation is highly specialized. The judicial decisions, IRS rulings, regulations and other interpretations are complex.

BKD's engineers are experienced in segregating costs and applying this complex body of law to your circumstances.

Our experience in conducting successful cost-segregation studies means your study is likely to withstand IRS scrutiny and capture the costs that will earn tax benefits.

* * *

Contact your BKD Financial Institutions Group advisor for more information about real estate cost segregation.❑

How cost-seg studies work

BKD does cost-segregation studies for all kinds of businesses, including financial institutions, across the country.

In fact, some 70 other accounting firms hire BKD's engineers to conduct studies for them, In the past 12 months, this service has helped businesses accrue $51 million in tax benefits.

Our consultants and engineers recently completed a cost-segregation study for a 6,430 square-foot bank costing $1,352,800. It was a typical branch bank operation, though it had a little more office space than some comparable operations.

Cost segregation without bonus depreciation

Five-year property	$182,800
Seven-year property	$10,900
15-year property	$146,000
39-year property	$1,013,100
Benefit	**$53,000**

Cost segregation with 30% bonus depreciation

Five-year property	$182,800
Seven-year property	$10,900
15-year property	$146,000
39-year property	$1,013,1000
Benefit	**$62,000**

Cost segregation with 50% bonus depreciation

Five-year property	$182,800
Seven-year property	$10,900
15-year property	$146,000
39-year property	$1,013,100
Benefit	**$68,000**

To calculate the bank's benefit and bonus depreciation, a quantitative survey of construction was used that included construction drawings and specifications and cost data.❑

Check 21 finally becomes law. . .

(continued from page 1)

In an environment where paper checks are replaced entirely by electronic images, the cost savings and customer benefits could be quite substantial. Couriers, labor, check-handling equipment and many errors will be eliminated.

Institutions that continue to process paper checks along with IRDs and some electronic images could actually see costs increase significantly. The fixed cost of processing paper checks will remain, while additional IRD- and image-processing costs also will be incurred.

Your institution must carefully consider Check 21's long-term implications for these reasons, as well as for your customers.

How to prepare for Check 21

Many Check 21 details must be resolved, and it's unlikely it will revolutionize the payment system overnight. However, **all financial institutions should prepare to accept IRDs for payment by late 2004**.

In many cases, this will require changes or upgrades to existing systems. Many institutions will take advantage of this opportunity to implement image technology, helping to reduce costs and beat the competition to market with new image-based services.

General recommendations to help you prepare for Check 21 include:

- Learn as much as possible about Check 21 and how it will fundamentally change many long-standing banking practices
- Develop your Check 21 strategy NOW; with less than 12 months to prepare, initiate system upgrades as soon as possible
- Ask your check-processing vendor or service provider and your clearinghouse(s) about their Check 21 plans
- Consider Check 21's impact on customers and develop a plan to manage their expectations

Contact your BKD Technologies advisor to help you prepare for Check 21.❑

SAS 99: Fraud? Not my client!

by Bert Purdy, St. Louis

Attention senior financial officers, audit committee chairs and internal auditors. Have you discussed fraud with your external auditor? Be prepared to do just that.

It's difficult for many auditors to imagine a client capable of fraud, especially long-term clients.

Statement on Auditing Standards No. 99 (SAS 99), *Consideration of Fraud in a Financial Statement Audit*, requires auditors to accept the possibility that any material misstatement could be the result of fraud.

Effective for financial statement audits for periods beginning on or after December 15, 2002, the new standard increases the external auditor's responsibility for designing procedures to detect material misstatements in the financial statements.

To plan an audit under SAS 99, auditors will have to perform new procedures, many of them outside the traditional audit process, including brainstorming sessions, using information-gathering and analytical procedures and assessing fraud risks within a company.

Audited companies also can expect to see SAS 99-related procedural changes, the most obvious involving the interview process.

Audit personnel, typically the audit team's partner or manager, are required to interview a company's senior financial officers, audit committee chairs and internal auditors.

Other company personnel also may be selected for interviews focusing on the company's risk, controls and tone related to fraud that may result in material misstatements in the financial statements.

Based on interview findings, the audit team will design procedures to perform during the audit that focus on risks of material misstatement because of fraud. For example, SAS 99 clearly establishes management override of controls to be such a risk.

The new standard also requires "unpredictable" audit procedures for each engagement, ranging from using completely new procedures to increasing the scope of tested items.

The way an audit is performed won't drastically change, but SAS 99 should change the way auditors view fraud and may help them identify areas of risk they were unaware of before.

Contact your BKD Financial Institutions Group advisor for more information about SAS 99.❑

FAS 150: Recording equity as a liability

by Bert Purdy, St. Louis

In May 2003, the Financial Accounting Standards Board (FASB) issued **Statement of Financial Accounting Standards No. 150** (FAS 150), *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity.*

FAS 150 provides guidelines for when to report financial instruments as liabilities or equity. Under FAS 150, many instruments previously classified as equity will be reclassified as liabilities:

- Mandatorily redeemable equity instruments, *e.g.*, mandatorily redeemable preferred stock
- Instruments that require the company to repurchase shares by transferring assets, *e.g.*, forward-purchase contracts
- Certain unconditional or conditional obligations that may or must be settled by issuing a variable number of shares

Instruments with characteristics of both liabilities and equity will be reviewed in a later phase.

FAS 150 defines shares redeemable upon *death* to be manditorily redeemable, so accounting for many stock repurchase or buy-back arrangements may be affected by implementation of the new standard.

Except for mandatorily redeemable financial instruments of nonpublic entities, the statement is generally effective at the beginning of the first interim period beginning after June 15, 2003.

Changes are to be implemented by reporting the cumulative effect of a change in accounting principle in the period of adoption.

To clarify FAS 150, four FASB Staff Positions (FSP) were issued, the most recent November 7, 2003.

Most importantly, FSP FAS 150-3 generally defers the effective date to December 15, 2004, for instruments of nonpublic companies that are mandatorily redeemable on fixed dates.

For all other mandatorily redeemable instruments of nonpublic companies, the classification, measurement and disclosure provisions of FAS 150 are deferred indefinitely.❑

How to Reach BKD

For a complete list of our offices and subsidiaries and their contact information, go to bkd.com or call Director of Communications at 417 831-7283.

P.O. Box 1900
Springfield, MO 65801-1900

inFinet Resources
Independent Financial Institution Network

bkd.com

PRSRT STD
US POSTAGE PAID
SPRINGFIELD MO
PERMIT #801

Address Service Requested