

New standard changes reporting of losses on purchased loans

by Tim Follett, Wichita,
tfollett@bkd.com

Statement of Position 03-3 (SOP 03-3), *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, changes reporting of losses on purchased loans.

Issued last December by the Accounting Standards Executive Committee (AcSEC), SOP 03-3 addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment, if those differences are attributable, at least in part, to credit quality.

It prohibits financial institu-

tions from reporting allowances for loan losses at the acquisition date when loans are purchased individually or as pools.

Instead, institutions must identify differences between cash flows due contractually, those expected to be collected and the institution's initial investment. Institutions also must account for them as described in the remainder of this article.

The SOP is effective for loans acquired in fiscal years beginning after December 15, 2004—including loans acquired in business combinations—but excludes the following groups of acquired loans:

- ▲ Loans measured at fair value if all changes in fair value are

included in earnings, *i.e.*, loans classified as trading securities,

- ▲ Mortgage loans classified as held for sale
- ▲ Loans held by liquidating banks
- ▲ Revolving credit agreements, *e.g.*, credit cards, home equity loans, etc., if the borrower has revolving privileges at the acquisition date
- ▲ Loans that are retained interests as defined by the Financial Accounting Standards Board's (FASB) Emerging Issues Task Force (EITF) Issue No. 88-2

Loans must reflect evidence of deterioration of credit quality at acquisition to be subject to the SOP.

Once it is determined the SOP applies to a loan or group of loans, compute the following amounts as of the acquisition date:

- ▲ Undiscounted contractual payments
- ▲ Undiscounted cash expected to be collected
- ▲ Institution's initial investment

The difference between the undiscounted cash expected to be collected and the initial investment should be accreted to income on the level-yield basis over the life of the loan(s).

The difference between the amount of undiscounted contractual payments over the undiscounted cash to be collected is an "unacceptable difference."

This is basically an adjustment
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Don't put information security on hold

by Brian Hunter, BKD
Technologies, bdhunter@bkd.com

Information security is still *the* hot topic and for good reason. Security incidents are at an all-time high and continue to rise.

Couple this with a seemingly endless variety of new security exploits, and you have an atmosphere

ripe for attacks from hackers and—believe it or not—your very own employees.

What statistics show

According to a study from Deloitte & Touche released in May, financial institutions (FIs) are coming under heavy attack:

- ▲ 83% of respondents acknowledged an outside break-in, up 44% from last year
- ▲ 40% of the respondents reported financial losses caused by the attacks
- ▲ More than 25% of respondents said their security budgets have stayed flat
- ▲ *Phishing* attacks, *i.e.*, redirects

to fake bank sites are listed as one of the highest concerns

The recently released Federal Bureau of Investigation/Crime Scene Investigators' 2003 Computer Crime and Security Survey also vividly illustrates the seriousness of the issue. Of the 528 respondents:

- ▲ Loss from financial fraud estimated at \$10,186,400
- ▲ Financial loss from insider/employee abuses averaged more than \$11 million

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Tax-deferral opportunities

by James Anderson, Lincoln,
jmanderson@bkd.com

As community banks continue to battle shrinking net interest margins, noninterest—or fee income—is increasingly important to the bottom line.

In fact, according to the Federal Deposit Insurance Corporation's **Statistics on Depository Institutions Report**, noninterest income to earning assets for all commercial banks has increased 72% in the past 10 years. When

Uncle Sam gives approval to defer fees for federal tax purposes, they become even more valuable.

That's exactly what the Internal Revenue Service (IRS) did recently when it released three pieces of guidance related to recognition of credit card annual fees and late charges.

When are annual fees taxable to credit card issuer

In Revenue Ruling 2004-52, the IRS addresses two issues:

- ▲ Are annual credit card fees interest income?
- ▲ When are the fees taxable to the credit card issuer?

Under the ruling, an accrual-basis taxpayer issues credit cards. On some accounts, the issuer charges an annual fee to the cardholder and makes a group of benefits and services available to the cardholder, regardless of whether the cardholder uses them.

The fee is not considered due and payable until posted to the

account. Some of the fees are non-refundable while others may be refunded on a pro-rata basis if the account is closed by the cardholder during the fee period.

In addition, the ruling states the fees are not considered interest income because they are not an "amount that is paid in compensation for the use or forbearance of money."

Because the cardholders pay the annual fee in return for access to a group of benefits and services and not any *one specific* benefit or

FACTA provides fair access to credit & protection from identity theft

by Kevin Scribner, Little Rock,
kscribner@bkd.com

The *Fair Credit Reporting Act* (FCRA) was passed in 1970 to address a growing credit reporting industry in the United States and the consumer credit reports and investigative consumer reports it compiled on individuals.

In 1996, Congress set uniform national standards on credit reporting, amending FCRA, the first federal law to regulate the use of personal information by private businesses.

Congress revisited FCRA before it enacted the *Fair and Accurate Credit Transactions Act of 2003* (FACTA), which was signed

into law to provide all Americans fair and equal access to credit. It also offered more protection against the overwhelming consequences of identity theft.

Before 1996, there were no uniform rules on borrower information and credit reports. FACTA updates the progress this nation has made in recent years to help qualified Americans get fair access to credit.

Lenders did not always have consistent and/or full information about potential borrowers. Too often, they made broad assumptions and decisions about categories of people instead of looking at individuals and their personal credit histories.

In our economy, reliable access to credit and capital is essential to growth and prosperity, and FACTA helps make that possible.

It also confronts the problem of identity theft to help the growing number of Americans victimized by criminals who assume their identities and turn their financial affairs into chaos.

FACTA gives the federal government the authority to:

- ▲ Ensure lenders make decisions on loans based on full and fair credit histories, not on discriminatory stereotypes

In our economy, reliable access to credit and capital is essential to growth and prosperity, and FACTA helps make that possible.

- ▲ Improve credit information quality and protect consumers against identity theft
- ▲ Give every consumer the right to one free copy of their credit report every year
- ▲ Require merchants leave all but the last five digits of a credit card number off store receipts
- ▲ Create a national system of fraud detection to make identity thieves easier to apprehend
- ▲ Establish a nationwide system

of fraud alerts for consumers to place on their credit files

- ▲ Require regulators to devise a list of red-flag indicators of identity theft, drawn from the patterns and practices of identity thieves
- ▲ Require lenders and credit agencies to take action before a victim knows a crime has occurred

During the first quarter, the Federal Trade Commission and the Federal Reserve Board approved publication in the **Federal Register** of "Interim Final Rules."

This notice sets December 31, 2003, as the effective date for those FACTA provisions that determine the relationship between the FCRA and state laws and provisions that authorize rulemaking authority for the agencies.

* * *

Contact your BKD Financial Institutions Group advisor for more information about FACTA and its effect on your financial institution. □

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for credit card issuers

service, the fees are not compensation for the use or forbearance of money. Accordingly, annual credit card fees are not interest income for tax purposes.

Next, the ruling indicates the fees are taxable to the issuer when they are posted to the cardholder's account, partially because of the "all events test."

Unlike cash-basis taxpayers, accrual-basis taxpayers include items in income when all events have occurred that fix their right to the income and the amount of the income is known.

The all-events test is satisfied through the earlier of a payment due date, an actual payment or performance. Because the annual credit card fees are due when posted to the account, the all-events test is met once the fee is posted to the account.

So, where's the deferral opportunity?

When the above ruling was issued, it told credit card issuers they were currently taxed on credit card annual fees the instant they were posted to each cardholder account.

On the same day, the IRS released Revenue Procedure 2004-32, which allows taxpayers to change their recognition of the annual card fee income to conform to the earlier ruling, *i.e.*, to use the ratable inclusion method (RIM) to defer recognition of the fees.

Under RIM, the annual credit card fee is recognized in income ratably over the period covered by the fee.

Example: Taxpayer is an issuer of credit cards and an accrual basis calendar-year taxpayer. December 1, 2004, the taxpayer charges a customer account a \$100 fee for the 12-month period beginning December 1, 2004.

Under RIM, the taxpayer would report 1/12 of the fee or \$8 as taxable income for the period ending December 31, 2004, and the remaining \$92 in the subsequent year.

To be eligible for RIM, the card issuer must include in taxable income any unrecognized and non-refundable portion of the annual fee for any card or account cancelled or closed during the year.

Deferral for late fees

In Revenue Procedure 2004-33, the IRS addresses the issue of fees charged to cardholders for delinquent payments.

Following the same logic discussed earlier—interest defined as compensation for use or forbearance of money—credit card late

fees are appropriately treated as interest where:

- ▲ The credit card late fee is separately stated on the cardholder's account when the late fee is imposed
- ▲ The late fee (under the credit card agreement) is not charged in whole or in part for property or services performed by the card issuer for the benefit of the cardholder

More specifically, the interest is treated as creating or increasing original issue discount (OID) on a pool of credit card loans. Following the procedure, the late fee income would be deferred for tax purposes and recognized as interest under the OID rules.

The deferral benefit may vary for your institution depending on

the rate of payment on credit card accounts and present value assumptions. Your BKD tax advisor can help you with these calculations.

Does this apply to noncredit card issuers?

While the ruling and procedures above are directed toward credit card issuers, there are potential applications to other types of noninterest income generated by community banks.

Any accounting method changes not specifically mentioned above require prior IRS approval. Your BKD tax advisor can help you determine how these tax-deferral benefits might apply to your institution. □

Market commentary: 2nd quarter active for banking transactions

by Patrick Hayes, BKD Financial, LLC, phayes@bkd.com

The second quarter was very active for banking transactions nationwide, including BKD's service area, continuing the trend beginning late 2003 when Bank of America, J.P. Morgan and several other large institutions announced acquisitions.

In the past, larger transactions have typically jump started banking merger and acquisition activity, and this has been no exception.

So far in 2004, BKD's service area has seen 62 transactions, with 34 occurring in the second quarter. This compares with 29 transactions for the first half of 2003, when only 13 took place during the second quarter.

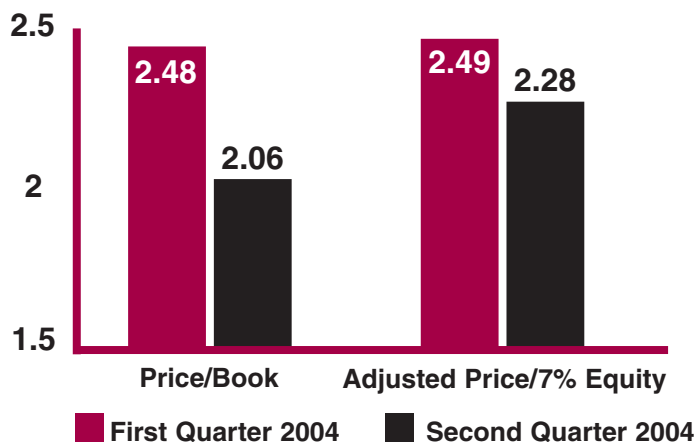
The improving economy and

the increase in interest rates should allow this trend to continue or even accelerate as the banking industry begins another round of consolidation.

While multiples slipped during

the second quarter, the median adjusted price to 7% equity multiple remains over 2.25 and price to net income exceeds 21 times, both of which are favorable if an institution is considering a sale. □

The Median First & Second Quarters



New standard changes reporting. . .

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to the carrying amount of the loan and what would previously have been reported as an allowance for loan losses.

The acquirer's initial investment, *e.g.*, what the loan or group of loans should be recorded at on the balance sheet, is the amount paid to the seller plus any fees paid or less any fees received.

In a business combination, the initial investment should be the allocation of fair value to loans or

groups of loans in accordance with FASB **Statement No. 141**, *i.e.*, the present value of amounts to be received.

Any subsequent increases in expected collections are generally recognized prospectively through adjustment of the loan's yield over its remaining life, while decreases should be recognized as impairments.

The SOP explicitly prohibits carrying over or creating a valuation allowance in the initial ac-

counting for all loans acquired within the SOP's scope. It prohibits investors from displaying the "accretable yield" and "nonaccretable difference" in the balance sheet.

Loss accruals or valuation allowances should reflect only those losses incurred by the acquirer *after* the acquisition, *i.e.*, the present value of all cash expected to be collected that will ultimately not be received.

While the SOP does not affect the accounting for loans originated,

certain modifications to existing software and systems may be necessary to:

- ▲ Identify separately purchased loans from originated loans
- ▲ Allow for the adjustment of the loan yield based on certain computations
- ▲ Gather information for added financial statement disclosures to comply with the SOP

This SOP will significantly affect purchased loans. It will require a substantial amount of work to determine the "accretable yield" and "nonaccretable difference," to compute the income recognizable, *i.e.*, yield adjustment.

* * *

Contact your BKD Financial Institutions Group advisor for more information about SOP 03-3 and for help with planning opportunities for your financial institution. □

Don't put information security. . .

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- ▲ 56% of surveyed respondents detected computer system compromises within the last 12 months
- ▲ 45% of respondents reported one to five attacks from the Internet within the last 12 months
- ▲ 82% of respondents reported attacks from independent hackers, while 77% reported attacks from disgruntled employees

and the Internet, and information security is a top priority. Security threats are real, coming from hackers or worse—from disgruntled employees.

BKD Technologies helps financial institutions with security risk improvements and regulatory compliance issues. We also perform regular security assessments and penetration tests, which can greatly reduce your security threats.

We do not sell security products or network services to financial institutions, so we can offer objective advice in the areas of:

- ▲ Risk assessments

- ▲ Regulation-based security control assessments
- ▲ Network penetration testing
- ▲ Periodic network vulnerability scanning
- ▲ Business continuity and disaster recovery planning
- ▲ Electronic banking reviews

* * *

For more information about improving your institution's information security, contact your BKD Financial Institutions Group or BKD Technologies advisor. □

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