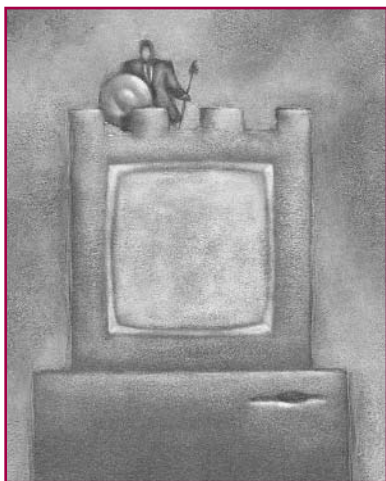


Financial Alert

Management & Compliance Solutions for Financial Service Organizations

May 2005



Security still tops technology concerns

sponse was overwhelming: **systems security.**

For the sixth consecutive year, BKD, through its InFinet Resources alliance, conducted a nationwide survey of mem-

bers of the Independent Community Bankers of America.

Results from the 2004 Community Bank Technology Survey help BKD determine banking technology trends and concerns.

Long-term decisions

Not only is security a regulato-

ry focal point, it's also what 63% of the survey's respondents cited as the biggest long-term technology decision they face.

Though systems security is deemed the number-one technology decision, 60% of the respondents said they do not have a chief information officer (CIO), a chief technology officer (CTO) or other full-time staff member dedicated to technology.

Of interest are the following security-related survey responses:

- ▲ 95% have a firewall
- ▲ 50% outsource intrusion detection services
- ▲ 24% use in-house intrusion detection software
- ▲ 61% have had external network assessments
- ▲ 55% have had internal network assessments
- ▲ 26% do in-house network security monitoring 24/7
- ▲ 33% outsource network security monitoring 24/7

Respondents report using a variety of methods to stay abreast of computer or physical vulnerabilities.

To stay current, 67% use Microsoft or other technology-provider web sites (the most widely used resources), and 72% use an e-mail notification service.

Internet use growing

Eighty-nine percent of the respondents report their institutions have Internet access, and 92% said some if not all employees are assigned e-mail addresses.

Eighty-two percent said their institutions maintain a web site that offers online banking services. The most common of these services allow customers to:

- ▲ Pay bills electronically
- ▲ Update account information
- ▲ View imaged checks
- ▲ Apply for loans and credit cards
- ▲ Open deposit accounts

Technology budgets

Survey participants were asked
(continued on page 4)

by Jerry Lowrance, BKD Technologies, Springfield, jlowrance@bkd.com

Officers of approximately 8,700 financial institutions were recently asked to identify their biggest technology concern. Their re-

FAS 123R revises stock option treatment

by Dustin Cuttriss, Fort Wayne, dcuttriss@bkd.com

Recently issued revised Financial Accounting Standards Board (FASB) statement will require financial institutions to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees.

For public institutions (other than small business issuers), a recent Securities and Exchange Commission (SEC) action makes revised FASB Statement No. 123, *Share-Based Payment* (FAS 123R), effective at the beginning of the

entity's first fiscal year that begins after June 15, 2005.

For small public institutions (small business issuers), the recent SEC action makes the new requirements effective at the beginning of the entity's first fiscal year that begins after December 15, 2005.

For privately held institutions, the effective date is at the beginning of the entity's first fiscal year that begins after December 15, 2005 (January 1, 2006, for calendar year-end institutions).

What 123R applies to

FAS 123R applies to all share-based payment transactions for ac-
(continued on page 3)

In this issue

- ✓ Overdraft protection programs: final guidelines announced
- ✓ FACT Act's final rules require ISP modifications
- ✓ M&A trends for financial institutions



E-subscribe to Financial Alert

An e-subscription to **Financial Alert** is a wise investment for any financial institution because it's easy, fast and free.

To receive your next issue electronically, follow the sign-up instructions at <http://www.bkd.com/enews/>.

As always, your e-mail address and other personal information will be kept in strict confidence and will **never** be sold to outside vendors or shared with anyone outside BKD. □

FACT Act's final rules require ISP modifications

by Sarah Farrell, Kansas City, sfarrell@bkd.com

As you may have heard, final rules have been issued under the *Fair and Accurate Credit Transactions Act of 2003* (FACT Act) for the proper disposal of consumer information.

Under the FACT Act's final rule, regulators amended **Guidelines Establishing Standards for Safeguarding Customer Information**, which was previously mandated by the *Gramm-Leech-Bliley Act of 2000*.

These earlier guidelines required financial institutions to maintain information security programs (ISPs). Currently, ISPs need only cover individuals that have a "continuing relationship" with a financial institution.

The FACT Act's final rules require ISPs to address the proper disposal of "consumer information" derived from a consumer report, even when a continuing relationship is not established.

The revised guidelines are effective **July 1, 2005**, so financial institutions should begin taking steps to modify their current ISP.

Confidentiality agreements with third parties also may have to be amended if they refer only to "customer" information. Such contracts must be modified no later than July 1, 2006. □

Overdraft protection programs:

by Sean Kulczycki, St. Louis, skulczycki@bkd.com

A recent industry trend is to promote or advertise overdraft protection programs, commonly known as "bounced-check protection."

Financial institutions offer these services as an alternative to traditional methods of covering overdrafts, *e.g.*, overdraft lines of credit or automated-transfer programs.

Generally, customers are told bounced-check protection is a feature of their account and—as long as their account remains in good standing—overdrafts will "typically" be paid up to an aggregate limit set by the institution.

These programs are proving to be very popular. Customer accept-

ance has grown, and the level of regulatory concern has kept pace, recently culminating in the February 18, 2005, issuance of **Joint Guidance on Overdraft Protection Programs (Joint Guidance)**.

Collectively authored by each of the industry's federal regulatory agencies, the **Joint Guidance** addresses three general areas of concern: Safety & Soundness Considerations, Legal Risks and Best Practices. Following is a summary of each area:

Safety & Soundness Considerations - The **Joint Guidance** encourages financial institutions to adopt written policies and procedures to adequately address credit, operational and other risks related to overdraft protection programs.

These policies and procedures should establish account-eligibility standards, dollar-limit decision criteria and ongoing procedures to monitor accounts to ensure credit risk is in line with expectations.

Financial institutions will be expected to develop prudent risk-management practices, including specific time frames consumers must follow in paying off overdraft balances.

The **Joint Guidance** also recommends overdraft balances should generally be charged off when considered uncollectible but no later than 60 days from the date first overdrawn.

When reporting income and loss recognition on overdraft protection programs, the **Joint Guidance** requires financial institutions to follow generally accepted

Best practices for overdraft protection programs

Consumer marketing & communications

- ▲ Avoid marketing that encourages routine or intentional overdrafts
- ▲ Inform consumers of alternate overdraft-related services, such as overdraft protection lines of credit
- ▲ Train bank staff to properly explain the program's features, costs and terms
- ▲ Clearly explain the program's discretionary nature
- ▲ Avoid promoting "free" accounts and overdraft protection programs in the same advertisement
- ▲ Clearly disclose actual insufficient fund (NSF) fees, instead of saying "standard NSF fees will apply"
- ▲ Clearly state that fees count against the disclosed overdraft protection limit
- ▲ Clearly disclose that more than one fee may be charged against the account per day
- ▲ Explain the effect the order in which items are processed will have on the potential for fees

- ▲ Clearly disclose any fees charged on transactions, such as ATM withdrawals or debit-card purchases

Program features & operation

- ▲ Consider obtaining affirmative consent from consumers to participate or permit them to opt out
- ▲ Where possible, provide notices that permit consumers to cancel transactions before fees are incurred
- ▲ Prominently distinguish actual balances from overdraft protection fund availability
- ▲ Notify consumers of the overdraft protection program each time they use it
- ▲ Consider a daily cap on fees
- ▲ Monitor excessive consumer use
- ▲ Avoid reporting information to a consumer-reporting agency when the program pays for overdrafts

final guidelines announced



accounting principles (GAAP) and the instructions for Reports of Condition and Income.

Report overdraft balances on regulatory reports as loans. Losses should be charged off against the allowance for loan and lease losses with documented procedures for estimating an adequate allowance.

In addition, if an institution advises customers of the available amount of overdraft protection, the **Joint Guidance** requires these amounts be reported as legally binding commitments for call report purposes.

Guidance also is provided on the proper risk-based capital treatment of outstanding overdrawn

balances and unused commitments.

Legal Risks - The **Joint Guidance** emphasizes that overdraft protection programs must comply with all applicable federal and state laws and provide a summary of the pertinent aspects of certain laws and regulations, including the *Federal Trade Commission Act*, *Truth in Lending Act*, *Equal Credit Opportunity Act*, *Truth in Savings Act* and the *Electronic Fund Transfer Act*.

Because most overdraft protection programs offered today include only those fees and terms related to the normal payment of an over-

draft, no new legal requirements appear to be imposed.

However, BKD recommends your institution review this portion of the **Joint Guidance**, especially if you offer overdraft protection programs not marketed as discretionary.

Best Practices - To help ensure consumers receive clear disclosure and an explanation of the operation, costs and limitations of an overdraft protection program, the **Joint Guidance** recommends financial institutions follow certain best practices to address marketing efforts, as well as program features and operations (see accompanying sidebar).

In summary, the **Joint Guidance** identifies the concerns the industry's regulatory agencies have about these popular programs. It also provides a set of standards for financial institutions to follow.

Generally, institutions must remember the agencies expect full, fair and clear disclosure to consumers of the operation, costs and limitations of overdraft protection programs, as well as appropriate management oversight.

Contact your BKD Financial Services Group advisor for more information about overdraft protection program compliance and other helpful compliance tools. □

New treatment for stock options. . .

(continued from page 1)
quiring goods or services, including:

- ▲ Issuance of shares
- ▲ Issuance of share options (stock options)
- ▲ Incurring liabilities whose settlement is based, at least in part, on the price of the entity's shares or other equity instruments
- ▲ Settling obligations by issuing the entity's equity shares or other equity instruments

The only exception: shares held in an ESOP that are still accounted for in accordance with the American Institute of Certified Public Accountants' Statement of Position No. 93-6, *Employers' Accounting for Employee Stock Ownership Plans*, (SOP 93-6).

Original 123 differed

The original FAS 123 encouraged the use of grant-date fair value method of accounting for equity-based compensation.

However, it did provide financial institutions the opportunity to continue using the intrinsic-value

method provided by Accounting Principals Board (APB) No 25.

APB No. 25 was applicable as long as the footnotes to the financial statements disclosed what the pro-forma impact on net income would have been had the preferable fair value method been utilized.

Most institutions used this approach because it resulted in no compensation costs being recognized in the income statement.

FAS 123R supersedes both FAS 123 and APB No. 25, and the result is compensation costs related to equity-based compensation will now be required to be recognized in the income statement.

What 123R requires

FAS 123R does not require a specific valuation technique to determine the grant-date fair value of employee stock options and other equity-based compensation issued to employees.

Estimate the value using option-pricing models adjusted for the unique characteristics of the instruments.

Valuation models that meet the FAS 123R criteria include:

- ▲ Lattice models, such as a binomial model
- ▲ Closed-form models, such as the Black-Sholes model

The compensation cost recognized in the income statement for equity-based awards will generally be recognized over the vesting period based on the grant-date fair value of the award.

FAS 123 allowed forfeitures to be accounted for, either by estimating the number of forfeitures at the grant date or accounting for the effects of the forfeitures when they occurred.

FAS 123R removes this option and requires estimation of forfeitures at the date of grant with the possibility of subsequent revisions.

In addition, FAS 123R will generally require expensing of employee stock purchase plans (ESPP).

Historically, ESPP permitted participants to purchase an employer institution stock at a discount up to 15%, and the institution did not recognize compensation cost on the income statement.

An employee would be permitted to purchase employer shares at

a price of 85% of the lower of the stock price either at the end of the purchase period or at the beginning of the look-back period, which is generally six months.

FAS 123R will require institutions to record compensation cost equal to the sum of any discount and the fair value of the look back.

If the institution's plan limits the discount to 5% or less and meets certain other criteria, the ESPP will not be considered compensatory under FAS 123R, and compensation cost will not be required to be recorded on the income statement.

FAS 123R is a complex statement that contains many new requirements and issues not fully addressed in this article.

Because this revised statement may have a significant impact on your institution's financial statements, contact your BKD Financial Services Group advisor for more information. □

Security still tops . . .

(continued from page 1)
if their 2004 technology budget is more than or less than what was allocated in 2003. Nearly half (48%) plan to increase spending, while 35% said they would not.

When asked if their technology is as advanced as they would like, 54% said it is "on target," 16% said it is better than expected and 2% said it is "cutting edge."

Conversely, 27% said their technology falls short of meeting their needs, and 1% said it lags behind. Again, nearly half (42%) said their 2004 technology budget is less than \$50,000. Keeping current appears

to be helping keep technology costs in line.

New priorities

To gauge respondents' new technology priorities, the survey asked which of 23 specific applications they plan to evaluate over the next 12 to 18 months.

New technologies were broken into five broad categories: imaging, document preparation, bank operations, Internet and "other."

Survey results indicate a continuing move to electronic-based work environments, with check and document imaging and Internet technologies leading the way:

- ▲ Imaged check-clearing networks lead with 66%
- ▲ E-mail statement delivery is second with 57%
- ▲ Document imaging applications are third with 52%
- ▲ Customer profitability and e-mail customer service applications are tied at 40%

Survey conclusions

Survey results point to the Internet's continued growth as a delivery channel for financial services, as well as an evolving communication vehicle, productivity tool and way to reduce expenses.

The Internet also has become more integral to the way financial institutions do business, and it will become even more important as new uses for it develop.

The continuing migration from paper to electronic data also is more prevalent in today's workplace. The volume of electronic data, and our reliance on it will only increase.

While access to paper data can be controlled by locks and alarms, electronic data may not be secured so easily. New external and internal risks are discovered almost daily and remind us that unauthorized access to electronic data is still a very real possibility.

Increasing reliance on the Internet to communicate information—coupled with the growth of the

electronic workplace—indicates security will continue to be the number one technology concern for financial institutions.

* * *

For a copy of the survey and its findings, contact your BKD Financial Services Group advisor or visit <http://www.bkd.com/docs/industry/InfinetSurvey-2004.pdf>.

Your BKD Technologies advisor can help you interpret what the results mean to your financial institution and can help you turn technology into a competitive business advantage. □



M&A trends for financial institutions

by Pat Hayes, BKD Corporate Finance, LLC, phayes@bkd.com

Compared to 2004, the number of announced merger and acquisition transactions in the BKD service area slowed dramatically for the first quarter of 2005.

But BKD's service area isn't suffering this trend alone; announced transactions decreased nationwide over last year as well.

The first quarter of 2004 had 28 announced transactions while 2005 came in with only 14. As might be

expected, the lower number of transactions announced translated into lower multiples being paid.

For the BKD service area, price/equity decreased from 2.48 times in 2004 to 1.72 times in 2005. Price/net income dropped to 18.23 times in 2005 compared to 22.16 times during the first quarter of 2004.

The last three quarters of 2005 will have to significantly pick up the pace to reach the 101 announced transactions we saw in 2004. □



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

For a complete list of our offices and subsidiaries and their contacts, visit bkd.com or contact the communications specialist at the BKD office nearest you.



A member of Moores
Rowland International

About Financial Alert

The content in this newsletter comes from sources BKD believes to be reliable and authoritative; however, to apply specific information to your situation requires careful consideration of all the facts and circumstances. Please consult your BKD advisor before acting on any matter covered in this newsletter.

To change your mailing information or to add your name to our mailing list, call the communications specialist at the BKD office nearest you or call our administrative office at 417 831-7283. To inquire about topics covered in this newsletter, contact your BKD advisor or Jan House at 417 831-7283 or jhouse@bkd.com.

©2005 BKD, LLP All rights reserved

PRSR STD
US POSTAGE PAID
SPRINGFIELD MO
PERMIT #801

Address Service Requested