Financial Alert
Management & Compliance Solutions for Financial Service Organizations
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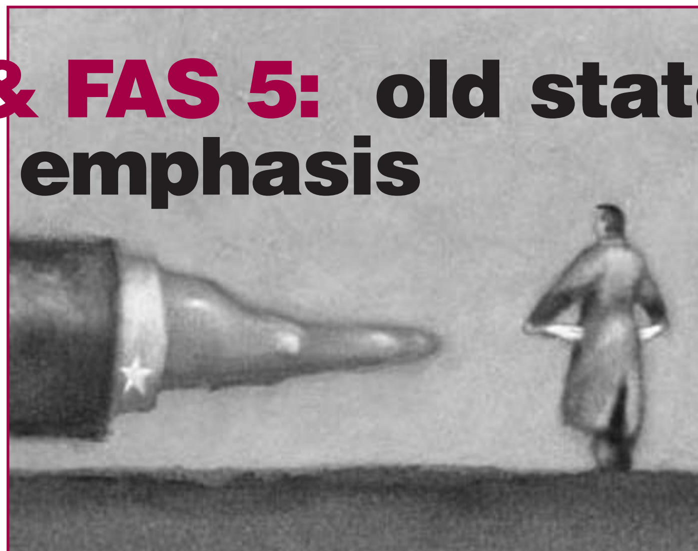
FAS 114 & FAS 5: old statements, renewed emphasis



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Regulators are placing renewed emphasis on two long-standing Financial Accounting Standards Board statements (FASs): FAS 114, *Accounting by Creditors for Impairment of a Loan*, and FAS 5, *Accounting for Contingencies*, issued respectively in 1993 and 1984.

For years, the various regulatory agencies and the Securities and Exchange Commission (SEC) have scrutinized FAS 114 and FAS 5 in an effort to apply them to the allowance for loan losses.

Historical perspective

In 1986, the SEC issued Financial Reporting Release (FRR) No. 28 to address certain registrants' lack of adequate procedural documentation for performing detailed loan portfolio reviews and determining the amounts of allowances and provisions for loan losses.

Since FRR No. 28's release, the SEC has asked many registrants why significant favorable or unfavorable trends in loan portfolio quality do not correspond with decreases or increases in the allowance for loan losses reported in the financial statements (as evidenced in statistical data presented in management's discussion and analysis and/or financial statements' notes).

SEC findings were similar to those in a 1994 General Accounting Office (GAO) report that found the loan loss allowances of many reviewed institutions included large supplemental reserves not generally supported by evidence or linked to an analysis of loss exposure.

In 1999, the SEC and the federal banking agencies formed a working group to study the allowance for loan loss issues and provide financial institutions improved guidance.

On July 6, 2001, the SEC and the FFIEC issued joint guidance: The SEC issued Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*; the FFIEC issued interagency guidance, "Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions."

Recognition of impairment

Determining when a loan is impaired per the guidelines of FAS 114 is a primary element of determining the allowance for loan losses and complying with the interagency guidance.

Under FAS 114, a loan is impaired when—based on current information and events—it is proba-

(continued on page 4)

New FFIEC manual sets expectations

by Sean Kulczycki, St. Louis,
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Of significant importance to bankers is the much-anticipated **Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual**, issued June 30 by the Federal Financial Institutions Examination Council (FFIEC).

The federal banking agencies and the Financial Crimes Enforcement Network (FinCEN) collaborated on the manual to ensure consistency in the BSA/AML examination process.

In addition to the revised examination procedures, the 330-page manual contains more than two-thirds narrative guidance and various resource materials.

New standards & expectations

According to the federal banking agencies, "… the manual does not set new standards; instead, it is a compilation of existing regulatory requirements, supervisory expectations and sound practices in the BSA/AML area." However, don't be misled by this statement.

(continued on page 2)

In this issue

✔ Jobs Act allows IRAs to be S corporations
✔ Proposed amendments ease regulatory burdens of smaller institutions
✔ M&A trends for financial institutions

Jobs Act allows IRAs to be

by Amy Johnson, Lincoln,
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The *American Jobs Creation Act of 2004* (Jobs Act) expanded the opportunities for banks to become S corporations by allowing individual retirement accounts (IRAs)—including Roth IRAs—to be S corporation shareholders.

Before the Jobs Act, IRAs were not eligible S corporation shareholders. In addition, the sale of IRA property to an IRA beneficiary was prohibited without disqualifying the IRA and subjecting the beneficiary to tax on the entire balance in the IRA.

The new Jobs Act provision intends to solve these problems and allow certain closely held banks to make an S election regardless of IRA ownership of its stock.

Provision has limitations

Despite the provision's positive changes, be aware of its limitations if you are considering S corporation status:

An IRA is an allowable S corporation shareholder only to the extent the bank stock was owned by the IRA when the Jobs Act was signed into law October 22, 2004.

This means any qualifying shares acquired by an IRA after October 22, 2004, will not be eligible for this exception.

In addition, if the stock is held by an IRA, the individual beneficiary must be a U.S. citizen or resident.

The new rules provide an exemption from the prohibited transaction rules for a sale of stock by an IRA to the individual beneficiary. The sale is subject to certain requirements:

- ▲ The sale is for fair-market value supported by an independent appraisal
- ▲ The stock was held by the IRA on October 22, 2004
- ▲ The sale must be in connection with the S election by the company
- ▲ The sale must be a single transaction for cash occurring no later than 120 days after the S corporation election is made
- ▲ The terms must be no more

New FFIEC examination manual. . .

(continued from page 1)

True, no new regulations or official policy statements have been issued, but if the purpose of the manual is to "ensure consistency," then by definition many bankers will be held to standards not previously imposed on a uniform basis.

Some of the "new" supervisory expectations the manual covers include:

Risk assessments - The manual requires examiners to "… determine whether the bank has adequately identified the risk within its banking operations, *e.g.*, products, services, customers and geographic locations, and incorporated it into the BSA/AML compliance program."

It also states, "… if the bank has not developed a risk assessment, or if the risk assessment is inadequate, the examiner must complete a risk assessment."

If you think your examiner will prepare your risk assessment without criticizing your BSA program, then think again.

Financial institutions also are expected to assess their risk pursuant to Office of Foreign Asset Control (OFAC) sanctions. The new manual describes an OFAC risk assessment as "… a fundamental element of a sound OFAC program."

Customer due diligence (also known as "know your customer") - The know-your-customer (KYC) concept isn't new, but the fact it's back with a new name may be a surprise.

Customer due diligence (CDD) is the phrase the manual uses to re-establish KYC requirements. It states "… the objective of CDD procedures should be to enable the bank to predict with relative certainty the types of transactions in which a customer is likely to engage." Sound familiar?

The manual goes on to say, "… under this approach, the bank will obtain information at account opening sufficient to develop an understanding of normal and expected activity for the customer's occupation or business operations."

Examiners are specifically required to determine whether the bank's CDD policies, procedures and processes are commensurate with the bank's risk profile.

Monitoring high-risk accounts - The manual provides further guidance that CDD information should be used to help banks monitor the activity of high-risk customers and entities.

The manual identifies the following types of accounts as high risk:

- ▲ Foreign financial institutions
- ▲ Nonbank financial institutions
- ▲ Senior foreign political figures
- ▲ Nonresident aliens
- ▲ Foreign corporations
- ▲ Deposit brokers
- ▲ Cash-intensive businesses
- ▲ Nongovernmental organizations and charities
- ▲ Professional service providers

For all the aforementioned account holders, examiners are required to determine whether the bank's system for monitoring such accounts and reporting suspicious activity is adequate given the bank's size, complexity, location and types of customer relationships.

Making sense of it

Banks will have to allocate substantial additional resources to their BSA/AML programs or face an increased risk of regulatory scrutiny and/or action.

Banks should perform a BSA/AML risk assessment and implement a system to identify and monitor the accounts of its high-risk businesses.

To do this effectively, banks may have to obtain additional CDD information at account opening.

Remember, this article addresses only some of the key issues the manual mentions. All BSA officers should carefully review it in its entirety with an eye to other applicable recommendations worth implementing.

* * *

Contact your BKD Financial Services Group advisor for more information about the **FFIEC BSA/AML Examination Manual** and other BSA requirements. ❑

S corporation shareholders

favorable than those available to an unrelated party

It's important to remember the IRA's share of S corporation income will be subject to the tax on unrelated business income (UBIT).

In the event the IRA sells the bank stock to the beneficiary under the exemption provided in the new law, any gain on the sale also would be subject to UBIT.

A drafting error caused the statute to apply only to banks. Since almost all IRA-owned shares are bank holding-company shares, the provision won't help the industry until it's corrected to include bank holding companies.

To revise the statute's language, a technical correction was introduced July 21 in both the U.S. House and Senate.

Instead of "an IRA shareholder of a **bank**," it would read "an IRA shareholder of a **depository institution holding company**."

This correction will most likely be attached to either the Highway Bill or the Budget Reconciliation Act, with passage expected later this year, possibly in October or November.

Contact your BKD Financial Services Group advisor to learn more about how this new Jobs Act provision could affect your institution. ❑

Proposed amendments ease regulatory burdens of smaller institutions

by Craig Liechty, Cincinnati, cliechty@bkd.com

At its July 19 board meeting, the Federal Deposit Insurance Corporation (FDIC) proposed changes to the annual independent audit and reporting requirements and to audit committee requirements (FDIC's Part 363).

The proposed amendments, effective December 31, 2005, would apply to all insured institutions, both public and nonpublic. The FDIC is currently soliciting comments about them through September 15.

Under current "FDICIA reporting requirements" (Part 363), institutions with total assets of $500 million or more must submit an annual report to the FDIC and other applicable agencies that includes:

- Audited financial statements
- A statement of management's responsibilities
- Assessments by management on the effectiveness of internal control over financial reporting
- Compliance with certain laws and regulations
- An auditor's attestation report on internal control over financial reporting

In addition, Part 363 requires each financial institution maintain an independent audit committee comprised of outside directors independent of the institution's management.

Easing regulatory burdens

To relieve some of the regulatory burdens of smaller institutions, the proposed amendments would raise the threshold for each insured depository institution from $500 million to $1 billion or more in total assets.

The proposed amendment to the audit committee requirements would allow an outside director for financial institutions with between $500 million and $1 billion in total assets to include a consultant or legal counsel to the institution, a relative of an officer or employee of the institution or the owner of 10% or more of the institution's stock.

However, the FDIC encourages institutions between $500 million and $1 billion to make a good faith effort to establish an audit committee comprised of outside directors independent of management.

SOX requirements impose Part 363 revisions

The FDIC estimates 1,000 of the nearly 14,000 FDIC-insured institutions would be subject to Part 363, which represents approximately 75% of the assets held by insured institutions.

The amendments do not relieve public companies from any of the requirements of the *Sarbanes-Oxley Act of 2002* (SOX), and the FDIC is still working to identify other aspects of Part 363 that—after SOX was passed—may need revision.

Further FDIC guidance is forthcoming for insured institutions subject to both the FDICIA reporting requirements and SOX Section 404.

* * *

For more information about applicability and implementation issues for either FDICIA reporting requirements or SOX, please contact your BKD Financial Services Group advisor. ❑

M&A trends for financial institutions

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

The number of announced transactions in the BKD service area picked up slightly in the second quarter of 2005 but still remains off the pace set in 2004. Seventeen transactions were announced in the second quarter of 2005 compared to 22 in the second quarter of 2004.

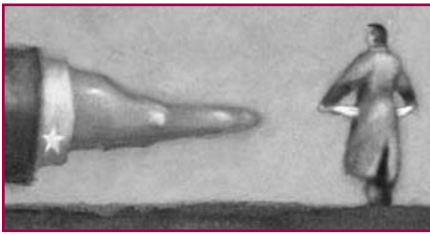
Through the second quarter, 31 total transactions have been announced in the BKD service area, compared to 50 in 2004.

Nationally, the market showed a slight rebound as the number of deals announced in the second quarter of 2005 was the same as those announced during the same period of 2004.

The second quarter proved to be an interesting quarter for pricing as price/equity and price/net income moved in contradictory directions.

For the BKD service area, price/equity decreased from 2.27 times in 2004 to 1.73 times in 2005; however, price/net income increased to 30.22 times in 2005 compared to 22.55 times during the second quarter of 2004.

The second half of 2005 will have to pick up the pace significantly to reach the 101 announced transactions we saw in 2004. ❑



FAS 114 & FAS 5. . .

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ble that a creditor will not be able to collect all amounts due according to the loan agreement's contractual terms.

"Probable" means likely to occur under FAS 5. "All amounts due" means the contractual interest and principal payments will be collected as scheduled in the loan agreement.

FAS 114 does not apply in cases of insignificant delay or insignificant shortfall in amount of payment. A loan isn't impaired during a period of delay in payment provided the creditor expects to collect all amounts due, including interest accrued at the contractual interest rate for the period of the delay.

Measurement of impairment

FAS 114 generally requires impairment to be measured loan by loan; however, it does permit impaired loans with similar risk characteristics to be aggregated and impairment to be measured by historical statistics.

FAS 114 requires creditors to measure impairment based on the present value of expected future cash flows discounted at the:

- ▲ Loan's effective interest rate
- ▲ Loan's observable market price
- ▲ Fair value of the collateral if the loan is collateral dependent

A creditor may choose a loan-by-loan measurement method. According to some regulators, FAS 114 would consider all nonaccrual loans and loans graded substandard or worse as impaired loans requiring impairment measurement.

FAS 114 also requires creditors to consider estimated costs to sell on a discounted basis if the costs are expected to reduce the cash flows available to satisfy the loan.

If the measure of the impaired loan is less than the recorded investment in the loan, a valuation allowance should be established.

Applicability to loans

FAS 114 applies to both collateralized and uncollateralized loans, with the exception of:

- ▲ Large groups of smaller-balance homogeneous loans collectively evaluated for impairment, *e.g.*, credit card, residential mortgage and consumer installment loans
- ▲ Loans measured at fair value or at the lower of cost of fair value, *e.g.*, mortgage loans held for sale
- ▲ Leases as defined in FAS 13
- ▲ Debt securities as defined in FAS 115

Develop policies consistent with guidance

Be familiar with guidance from FAS 114, FAS 5, the staff implementation guide for FAS 114 (Q&A114) and the FFIEC interagency policy statement. Develop policies and procedures consistent with it.

In addition, unless aggregation is permitted, analyze impaired loans individually for impairment.

Include a specific reserve in your allowance for loan loss adequacy calculations and separate the loan and related allowance from general reserve calculations.

Properly justify, through narratives, statistical information, economic conditions or other analysis conducted by management, the reasons for any unallocated reserves.

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Contact your BKD Financial Services Group advisor for more information or for assistance in applying FAS 114 and FAS 5 guidance to your financial institution's policies and procedures.❏

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