



Financial Alert

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EITF's new guidance for split-dollar life insurance

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The Emerging Issues Task Force (EITF) has reached final consensus on Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Aspects of Endorsement Split-Dollar Life Insurance Arrangements* (EITF 06-4). Effective for fiscal years beginning after December 15, 2007, the new accounting guidance requires either a cumulative effect adjustment to beginning equity or a retrospective application to all prior periods.

Arrangements may vary

Many institutions supplement executive compensation programs with various deferred compensation arrangements and may purchase life insurance for different reasons:

- ▶ Protection from losing key employees
- ▶ To informally fund deferred compensation and postretirement benefit obligations
- ▶ To provide tax-exempt investment returns

Life insurance policies are often obtained as an investment at the same time deferred compensation commitments are made to executives. The two most common arrangements are endorsement split-dollar life insurance and collateral assignment split-dollar life insurance arrangements.

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FAS 157: understanding & preparation are key to implementation

by Doug Van Meter, dvanmeter@bkd.com

Financial Accounting Standards Board (FASB) Statement No. 157 (FAS 157) establishes a single, authoritative definition of fair value, creates a framework for measuring it and expands disclosures about fair value measurements. It's effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those years.

New standard's applicability

The new standard applies only to fair value measurements that are already required or permitted by other accounting standards, such as FAS 115, FAS 141, FAS 144, etc., with some exceptions. FAS 157 applies to financial and nonfinancial assets and liabilities:

- ▶ Available-for-sale securities
- ▶ Impaired loans
- ▶ Mortgage servicing rights
- ▶ Other real estate owned
- ▶ Foreclosed assets held for sale
- ▶ Goodwill
- ▶ Preferred stock
- ▶ Deferred compensation agreements
- ▶ Contingencies (FAS 5 considerations)

FAS 157 & current practice

The definition of fair value retains the exchange price notion in earlier FASB definitions, such as within FAS 141, defined as the amount at which an asset (or liability) can be bought (or incurred) or sold (or settled) in a current transaction between willing parties, *i.e.*, other than in a forced or liquidation sale.

FAS 157 clarifies "the exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability."

The definition focuses on the price that would be received to sell the asset or the price paid to transfer the liability (an exit price). An exit price may be different than the price paid to acquire the asset or the price received to assume the liability (an entry price) in some situations.

Valuation & fair value

FAS 157 emphasizes fair value is not an entity-specific measurement but is market-based on the assumptions market participants would use to price the asset or liability. Three key valuation techniques are used to measure fair value:

Market approach - uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities

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FAS 157: understanding & preparation

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Income approach - uses valuation techniques to convert future amounts (cash flows, earnings) to a single present amount

Cost approach - based on the amount currently required to replace the service capacity of an asset (often referred to as the “current replacement cost”)

Single or multiple valuation techniques may be used in varying circumstances. If multiple valuation techniques are used to measure fair value, the results are evaluated for reasonableness and are weighted to establish the point most representative of fair value within a range.

The valuation techniques discussed above utilize observable and unobservable inputs clarified below:

- ▶ Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity
- ▶ Unobservable inputs are inputs that reflect the reporting entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances

The new standard establishes a fair value hierarchy (the hierarchy) to prioritize the inputs used in valuation techniques. There are three broad levels:

Level 1 - quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 - inputs other than quoted prices included within Level 1 that are either directly or indirectly observable for the asset or liability, including quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in inactive markets.

Level 3 - unobservable inputs for the asset or liability that are used to measure fair value to the extent observable inputs are not available, thereby allowing for sit-

uations where there is little, if any, market activity for the asset or liability at the measurement date.

The hierarchy gives Level 1 the highest priority for quoted prices (adjusted) in active markets for identical assets or liabilities. The lowest priority falls within Level 3 because of its unobservable inputs. The lower the level of the input of a fair value measurement, the more extensive the disclosure requirements.

To improve consistency in the fair value measurements, FAS 157 specifies the level within the fair value hierarchy in which a fair value measurement in its entirety falls should be determined based on the lowest level input that is significant to the measurement in its entirety.

For example, if the reporting entity holds a large number of similar assets or liabilities, *e.g.*, debt securities, that require measurement at fair value, a quoted price in an active market might be available (but not readily accessible) for each individual asset or liability.

In that case, fair value may be measured using an alternative pricing method that doesn’t rely exclusively on quoted prices, *e.g.*, matrix pricing, as a practical expedient. This example of an alternative pricing method would render the fair value measurement a lower-level measurement.

Disclosures & fair value

The amount and type of disclosures in financial statements will depend on the inputs used to measure fair value, *e.g.*, significant unobservable inputs. For inclusion with the disclosures, reporting entities must identify the following:

- ▶ Measurement of assets and liabilities on a recurring basis
 1. The fair value measurement at the reporting date
 2. The level within the fair value hierarchy in which the fair value measurements (in their entirety) fall, segregating fair value measurements within Levels 1, 2 and 3
 3. For fair value measurements us-

ing unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to (1) total realized and unrealized gains and losses; (2) purchases, sales, issuances and settlements (net); and (3) transfers into and out of Level 3

4. Identify where changes in unrealized gains and losses are reported in the statement of income relating to the fair value measurements for assets with unobservable inputs, held as of the reporting date
5. For annual periods only, the valuation technique(s) used to measure fair value and a discussion of any changes in valuation techniques during the period

- ▶ Measurement of assets and liabilities on a nonrecurring basis
 1. The fair value measurement recorded during the period and the reason for the measurements
 2. The level within the fair value hierarchy in which the fair value measurements (in their entirety) fall, segregating fair value measurements within Levels 1, 2 and 3
 3. For fair value measurements using unobservable inputs, a description of the inputs and the information used to develop the inputs
 4. For annual periods only, the valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques used to measure similar assets and/or liabilities in prior periods

Implementation issues

Implementation guidance of FAS 157 is limited; however, the reporting entity could, in part, consider the following:

- ▶ Obtain from third parties providing pricing services (such as the valuation of investments, as well as FAS 107 disclosures regarding fair value of finan-

are key to implementation . . .

cial instruments), an understanding of the method the third party uses to value assets or liabilities, including observable or unobservable inputs to determine where the inputs fall within the hierarchy.

- ▶ Obtain current appraisals on assets held and valued at fair value, including the valuation techniques and methodology used. Also substantiate the appraiser's qualifications to perform the appraisals.
- ▶ Understand valuation models used or obtained to perform valuation of assets or liabilities.
- ▶ Verify and document the valuation techniques used for reasonableness and accuracy.

Other considerations

The reporting entity should include market participant assumptions in evaluation of fair value, as well as documentation of valuation techniques.

These assumptions include the highest and best use of the asset as determined by market participants; the fair value measure is not an entity-specific measure that reflects only the entity's expectations for the asset. Transaction costs are not included in the valuation of assets or liabilities.

Assumptions must also include consideration of the following:

- ▶ Credit risk
- ▶ Restrictions on an asset's sale or use
- ▶ Nonperformance risk
- ▶ Adjustments for block trades (quoted prices should not be adjusted because of the size of the position relative to trading volume, *i.e.*, blockage factor)

After establishing a valuation technique, apply it consistently to each specific asset or liability. It may be necessary to change valuation techniques between reporting periods because measurements more representative of fair value may result following certain changes, including changes in market conditions, new information that becomes available or previ-

ously used information that is no longer available.

Revisions to valuation techniques or their application will be treated as a change in accounting estimate; they are to be reported in the current period and must include a footnoted disclosure.

The implementation issues of apply-

ing FAS 157 must be in place before interim or year-end financial statements are issued. It will require documentation of assets and liabilities that fall within the statement and the hierarchy, and a more thorough understanding of valuation techniques used to comply with its provisions and disclosures. ■

Accounting for the new deposit assessments

by Jason Rader, jrader@bkd.com

In 2006, President Bush signed into law the *Federal Deposit Insurance Reform Act of 2005* (the Reform Act). Among other things, it merged the Bank Insurance Fund and the Savings Association Insurance Fund into the Depository Insurance Fund (DIF). Later that year, the Federal Deposit Insurance Corporation (FDIC) issued several new rules to implement the Reform Act.

Perhaps the most noticeable and painful change has been the increase in the assessment amount most banks are required to pay. Beginning in June 2007, financial institutions that lacked sufficient credits were required to pay the higher assessments. The increases have been substantial, and the new assessments have given rise to accounting questions that require clarification.



Avoid payment mistakes

For the past few years, most banks have made only Financing Corporation (FICO) payments as their FDIC assessment. These were paid prospectively, meaning, they were paid in advance for the next quarter, so banks pre-paid these quarterly payments, then expensed them over the next quarter.

The new deposit assessments brought about by the Reform Act has not changed the handling of FICO payments, which are included on your quarterly statements and

should still be prepaid. However, the big difference now is how banks should account for the new deposit assessment that also appears on your quarterly statement.

These payments are made in arrears, which means you pay at the end of a period, not the beginning. In addition, the payments are made nearly three months in arrears, so there is a large lag between the time the assessment is actually paid and when the amount was accruable.

Heed warnings

The issue above was discussed in the March 2007 Call Report supplemental instructions that warned banks to remember to accrue an estimate of their deposit assessment for the first quarter, even though the final assessment statement would not be available until June.

For example, if your bank lacked sufficient credits to cover the deposit assessment you paid in June 2007, that payment was actually for the first quarter and should have been accrued in the first quarter.

Some banks have mistakenly recorded the deposit assessment paid in June as prepaid. They plan to expense it over the third quarter, when, in fact they should have had six months of expense *accrued* by June 30.

If your bank made this mistake—and operates on a fiscal calendar year—record the 12 months of expense in calendar 2007. Also, if your bank has yet to pay the quarterly assessments due to the one-time assessment credits, we urge you to monitor credit expiration to avoid getting caught short on your expense at year end. ■

Take stock of new act's bank-specific provisions

by Mary Ann Pipkin, mpipkin@bkd.com

In May, President Bush signed the *Small Business and Work Opportunity Tax Act of 2007* (the Act) that extends several popular tax breaks and is supposed to smooth the burden the increase to the federal minimum wage will have on small businesses. It also contains several new pro-S corporation changes, including two bank-specific provisions.

Bank director shares

To comply with national or state banking law, a bank director often owns bank stock and enters into an agreement stipulating the bank will reacquire the stock at the price the director paid for it (restricted bank director shares) when the director ceases to be on the board of directors.

A concern has been federal tax law provides that an S corporation may have no more than 100 shareholders and may have only one outstanding class of stock. The Act clarifies the treatment of bank director shares under the S corporation rules and provides that restricted bank director shares will not be taken into account as outstanding stock in applying the S corporation rules:

- ▶ The stock will not be treated as a second class of stock
- ▶ A director will not be treated as a shareholder of the S corporation if he/she solely owns restricted bank director shares
- ▶ The stock will be disregarded in allocating items of income, loss, etc., among the shareholders
- ▶ The stock will not be treated as outstanding for purposes of determining whether an S corporation holds 100% of the stock of a qualified S subsidiary

The new provision generally applies to taxable years beginning after December 31, 2006, but the provision providing restricted bank director shares are not treated as a second class of stock is retroactive to 1997, the first year a bank could elect S corporation status.

Reserve method

Under current law, banks using the tax

reserve method for bad debts are ineligible to make the S election. If a bank wants to become an S corporation, it must switch to the specific charge-off method, which results in recapture (inclusion in income) of the existing tax bad debt reserve over a four-year period. The amount recaptured is treated as built-in gain subject to both corporate- and shareholder-level taxes in the year of recognition.

The Act allows banks to recapture 100% of the tax bad debt reserve in the last C corporation year, eliminating the second layer of tax. Whether this option is the most advantageous for your bank depends on several factors, including the recapture amount and potential existing built-in losses.

Section 179 extended

Another provision could benefit community banks by extending and increasing the limits for electing to deduct the cost of qualified assets placed in service during the year. Before 2007, rather than depreciate qualifying property over a period of years,

banks could elect to immediately deduct up to \$112,000. This deduction began to phase-out if total qualifying property acquired exceeded \$450,000. The Act extends this provision to December 31, 2010. Beginning in 2007, it increases the expensing level to \$125,000 and the phase-out to \$500,000. For the same period, it also extends the inclusion of off-the-shelf computer software in the definition of qualifying property.

The Act's provisions are generally beneficial to financial institutions because they enhance the option to expense qualifying property and provide banks wanting to make an S corporation election with an additional option for recapturing the tax bad debt reserves. They also clarify the issue of qualifying bank director shares.

Covered here are only a few of the Act's provisions. Contact your BKD Financial Services Group advisor for a thorough overview of others that could affect your institution. ■

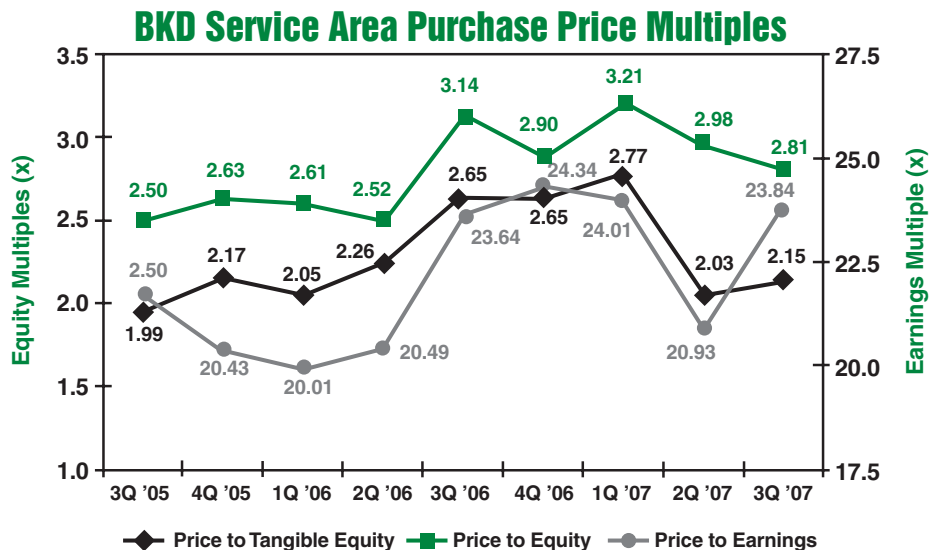
Third-quarter M&A trends for financial institutions

by Patrick Hayes, BKD Corporate Finance (BKDCF), phayes@bkd.com

BKDCF continues to see considerable M&A activity and favorable valuations throughout the banking industry and BKD service area. There were 27 announced

transactions in the third quarter, up from the 24 announced in the second quarter of 2007 and the 21 announced in the same period a year ago. Compared to last year's respective quarter, this marked the first time in five consecutive quarters that the

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BSA compliance remains banking agency priority

by Sean Kulczycki, skulczycki@bkd.com

For the past several years, compliance with the *Bank Secrecy Act* (BSA) has been a top priority for the federal banking agencies, a focus they reaffirmed July 19 by issuing a joint statement on BSA enforcement: the Interagency Statement on Enforcement of Bank Secrecy Act/Anti-Money Laundering Requirements (the Statement).

The Statement's primary message is if an insured financial institution fails to establish and maintain a BSA compliance program or fails to correct any previously reported problem with its BSA compliance program, the institution's regulatory agency will issue a cease-and-desist order.

The Statement indicates such action is required by the BSA/AML compliance provisions in Section 8(s) of the *Federal Deposit Insurance Act*.

Failure to set up & maintain BSA compliance program

The Statement indicates a banking agency will issue a cease-and-desist order for failure to establish and maintain a reasonably designed compliance program under the following conditions:

- ▶ The bank fails to have a written BSA compliance program that adequately covers required program elements

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EITF's new guidance . . .

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The primary difference between the two arrangements is the ownership and control of the policy: For an endorsement split-dollar life insurance arrangement, the institution owns and controls the insurance policy. For a collateral assignment split-dollar life insurance arrangement, the employee owns and controls the policy.

Policy structure affects proceeds & benefits

A typical endorsement split-dollar policy is structured so the institution purchases a life insurance policy to insure an employee's life. The institution then enters into a separate agreement that splits the policy's premium, and/or policy benefits, between the institution and the employee.

The institution owns the policy, controls all rights of ownership, and may terminate the benefits promised to the employee if he/she leaves the institution before a specified date or event, such as retirement.

The institution endorses a portion of the death benefits to the employee, and the employee designates a beneficiary for this portion of the death benefits. Upon the employee's death, his/her beneficiary receives the designated portion of the death benefits, and the institution receives the remainder of the death benefits.

Depending on how the policy is structured, the beneficiary's pro-

ceeds are either received directly from the insurance company or from the institution, which then remits the beneficiary's proportionate share once payment is received from the insurance company. The employee's portion of the death benefits is commonly based on one of three factors:

- ▶ Amounts that exceed the gross premiums paid by the employer
- ▶ Amounts that exceed the sum of the gross premiums paid by the employer plus an additional fixed or variable investment return on those premiums
- ▶ Amounts equal to a multiple of the employee's base salary at retirement or death (for example, twice the employee's base salary)

Impact of new guidance

The new guidance was issued due to diversity in the practice of accounting for the deferred compensation and postretirement aspects of typical endorsement split-dollar life insurance arrangements.

EITF 06-4 requires that policyholders (institutions) record a liability (and recognize ongoing expense) for postretirement death benefits provided by endorsement split-dollar arrangements using the accounting guidance in FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, or paragraphs six through eight of Accounting Principles Board Opinion No. 12, *Omnibus Opinion (Deferred Compensation Contracts)*.

The liability will be based on one of the following:

- ▶ The institution has effectively agreed to provide a death benefit, whether an insurance policy is in place or not; accrual will be based on the actuarial present value of the future death benefit as of the employee's retirement date
- ▶ The institution has effectively agreed to maintain the underlying insurance policy on the employee during retirement; the accrual will be based on the expected postretirement cost of maintaining such an insurance policy

The EITF has also reached a consensus on EITF 06-10, *Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements*. It, too, is effective for fiscal years beginning after December 15, 2007. While the details of EITF 06-10 are not discussed in this article, the impact could also be significant to many institutions.

Develop your action plan

Your life insurance or deferred compensation vendor(s) may have already contacted you to determine a course of action. If not, follow up with them soon to determine the financial impact of complying with EITF 06-4 and EITF 06-10.

If necessary, explore alternatives to existing arrangements, e.g., amendment, replacement or termination of existing programs. Review all split-dollar agreements to learn their potential impact. ■

BSA compliance remains . . .

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- ▶ Fails to implement a BSA compliance program that adequately covers required elements
- ▶ Has one or more defects in its BSA compliance program that indicate the written program or its implementation is ineffective

Failure to correct problems

To be considered a “problem” that a cease-and-desist order can be assessed, “a deficiency reported to the institution ordinarily would involve a serious defect in

one or more required components of the institution’s BSA compliance program or implementation thereof that a report of examination or other written supervisory communication identified as requiring communication to the institution’s board of directors or senior management as a matter that must be corrected.”

The Statement indicates a banking agency will not ordinarily issue a cease-and-desist order “unless the deficiencies it subsequently finds are substantially the same as those previously reported to the

institution.” It also indicates a cease-and-desist order will not be issued if an “institution has made acceptable substantial progress toward correcting the problem.”

The Statement makes it clear the emphasis on BSA compliance has not gone away. It is also a reminder that the easiest way to create regulatory problems is to ignore the problems your regulatory agency previously identified. Make a concerted effort to understand and correct all deficiencies it finds. ■

Third-quarter M&A trends . . .

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number of transactions increased.

Overall, transaction multiples for the third quarter of 2007 were mixed. A median price to tangible equity multiple of 2.15 is 5.9% higher than that of the previous quarter but 18.9% lower than the same quarter a year ago. The median price to 7% equity multiple decreased

5.7% to 2.81 from the previous quarter, and 10.5% from 3.14 during the same quarter in 2006.

Meanwhile, price to earnings rebounded significantly from its fall in the second quarter of 2007, reaching a third-quarter median of 23.84, representing a 13.9% quarterly increase and a slight increase from the 23.64 recorded in the same quarter of 2006.

Nationally, total announced transactions decreased with 75 announced in the third quarter of 2007 compared to 78 in the same quarter of 2006. For a further breakdown of second-quarter transactions, visit BKD Corporate Finance’s “Bank Merger Update” at bkd.com/docs/about/BankMergerUpdate.pdf. ■

Mark your calendar

November 6, 10-11 a.m. CT - Webcast

In “What Your Bank Needs to Know,” presenter Francis Godfrey covers how your institution can stay on top of the changing FIN 48 regulations. Contact Greg Cole for more information: 417.831.7283 or gcole@bkd.com.

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