

# BKD Financial Alert

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## Electronic statements: benefits, risks, liabilities

by Kristi Mehl, kmehl@bkd.com

The term paperless suggests lower costs and increased convenience, a boon to any business. Like the financial services niche, many industries have benefited from past technological advances and are eager to adopt new technology to help streamline processes, cut costs and satisfy customers.

But before you switch your financial institution to a paperless system, be aware of the related compliance risks and potentially significant liability issues that could instead prove quite costly and very inconvenient.

## Have consumer consent

The *Electronic Signatures in Global and National Commerce Act of 2000* (E-Sign Act) eases the transition to paperless commerce by allowing financial institutions to provide any required disclosure electronically as long as the required consumer consent provisions are followed.

The first electronic disclosure most financial institutions provide consumers is the monthly deposit account statement, as required by Regulation E.

More than just another “required” disclosure, the periodic statement also serves a critical function: It places responsibility on consumers to examine their account activity for unauthorized or fraudulent transactions.

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## New accounting for familiar transactions

by Michelle Mahoney  
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It seems like only yesterday when we discussed changes to the accounting for business combinations. Now, six short years later, the Financial Accounting Standards Board (FASB) has again made sweeping revisions, thanks to a joint project of the FASB and the International Accounting Standards Board (IASB) to converge the accounting for business combinations and noncontrolling interests.

The results of this effort are two new standards: FASB Statement (FAS) 141(R), *Business Combinations*, and FAS 160, *Noncontrolling Interest in Consolidated Financial Statements – An Amendment of ARB* (Accounting Research Bulletin) No. 51. Both apply to for-profit organizations (not-for-profit organizations are excluded) and have an effective date of periods beginning on or after December 15, 2008. Early adoption is prohibited.

FAS 141(R) replaces FAS 141 and is broader in scope because it applies to all transactions or events in which an acquirer obtains control of one or more businesses—not just when control is obtained by transferring consideration. Following is a brief summary of the significant changes:

- ▶ Definitions of business and business combination have been expanded, resulting in more transactions that qualify as a business combination.
- ▶ The acquirer will record 100% of all assets and liabilities of the acquired business, including goodwill, gener-

ally at the acquisition-date fair value (even in partial or step acquisitions). FAS 157 will be the standard used to measure fair value.

- ▶ In step acquisitions, equity interests the acquirer held prior to obtaining control will be remeasured to the acquisition-date fair value, with any gain or loss recognized in earnings. There will no longer be a blend of historical cost and fair value.
- ▶ Assets and liabilities acquired from contractual contingencies will be recognized at fair value on the acquisition date. Subsequent changes in fair value will be recognized in earnings until the contingency is ultimately settled.
- ▶ Assets and liabilities arising from noncontractual contingencies will be recognized at fair value on the acquisition date only if they are more likely than not to meet the definition of an asset or liability (FAS 5 is the previous standard for recognition and measurement).

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# New accounting for familiar transactions . . .

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- ▶ Acquisition and restructuring costs will be expensed in the period they are incurred; they will no longer be included as part of the purchase price to be allocated toward the amount recorded for the assets acquired or goodwill.
- ▶ Contingent consideration generally will be measured at fair value on the acquisition date, not when the contingency is resolved.

- ▶ Goodwill is generally calculated the same; however, in a bargain purchase situation, long-lived asset values will no longer be reduced. Instead, the bargain purchase will result in the recognition of a gain in earnings (this gain will not be classified as extraordinary).
- ▶ Subsequent adjustments to acquisition accounting are allowed during the measurement period (not to exceed one year) only for information

that becomes available about facts and circumstances existing at the acquisition date.

- ▶ Enhanced disclosures are required in the period of acquisition, in the period preceding the acquisition (if information is available before the financial statements are issued) and in periods following the acquisition period (on financial effects of any adjustments).

FAS 160 changes the accounting and reporting of noncontrolling interests (formerly referred to as minority interests) and the deconsolidation of a subsidiary. Following is a brief summary of its significant changes:

- ▶ Noncontrolling interests will be reported as a part of equity and as a separate component from the parent's equity.
- ▶ Income attributable to the parent and to the noncontrolling interests will be shown separately on the face of the income statement.
- ▶ Losses that exceed the noncontrolling interest will be allocated to the noncontrolling interest, where they were previously allocated to the parent.
- ▶ If control is maintained by the parent, changes in parent and noncontrolling interests will be shown as equity transactions.
- ▶ Upon a loss of control (deconsolidation), any gain or loss on the interest sold will be recognized in earnings and based on the fair value on the date the control is lost. Also, any retained ownership interest will be remeasured at fair value, with any gain or loss recognized in earnings
- ▶ Required disclosures will identify and distinguish controlling and noncontrolling interests.

Though the effective date of both standards is almost a year away, now is the time to consider how they will affect you, especially if you currently have noncontrolling interests or are considering a business combination in the near future. ■

## M&A trends for financial institutions

by Patrick Hayes, phayes@bkd.com

**M**&A activity and favorable valuations continue throughout the banking industry and BKD service area.

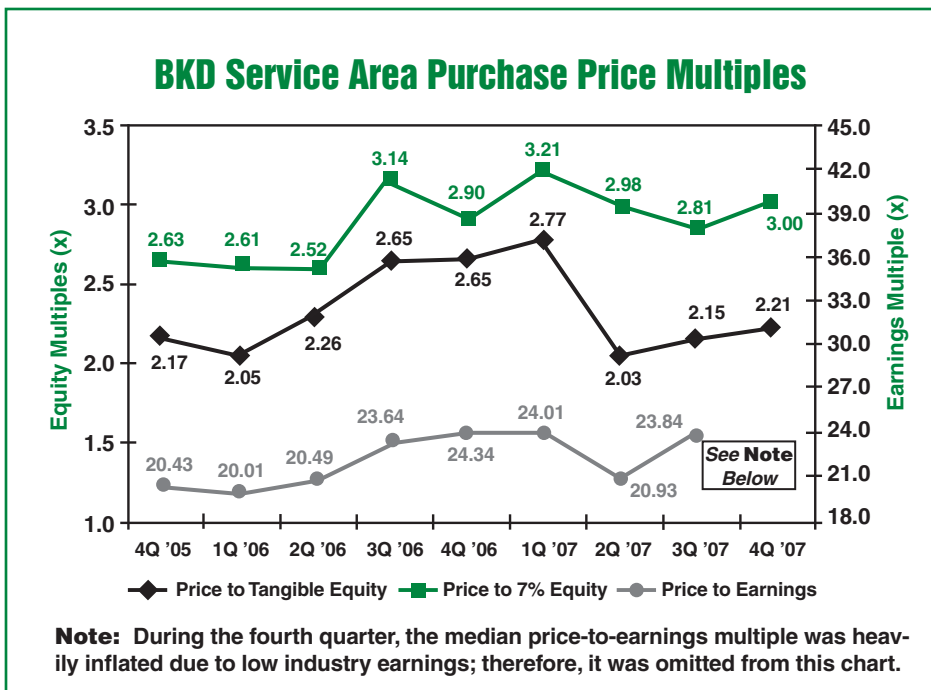
There were 15 announced transactions in the fourth quarter of 2007, down from the 23 announced in the same period a year ago and the 27 announced in the third quarter of 2007. However, transaction multiples for the fourth quarter of 2007 were favorable compared to multiples in the third quarter.

A median price to tangible equity multiple of 2.21 is 2.8% higher than

that of the previous quarter, but 16.6% lower than the same quarter a year ago. The median price to 7% equity multiple increased 6.8% to 3.0 from the previous quarter, and 3.4% from 2.9 during the same quarter in 2006.

Nationally, the total number of announced transactions decreased, with 45 announced in the fourth quarter of 2007 compared to 72 in the same quarter of 2006.

For a further breakdown of fourth-quarter transactions, visit BKD Corporate Finance's Bank Merger Update at [bkd.com/docs/about/BankMergerUpdate.pdf](http://bkd.com/docs/about/BankMergerUpdate.pdf). ■



# Tax treatment of nonaccrual loan interest

by Gary Genenbacher  
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**F**or accrual-method taxpayers, placing a loan on nonaccrual status or writing off interest receivable doesn't always result in the same treatment for tax return purposes.

A 2007 Internal Revenue Service (IRS) ruling clarified its position that most interest is includible in income despite certain rules that regulate financial statements and suspend the continued recognition of income. However, this method of reporting isn't always consistent with the necessary income tax reporting.

An accrual-method taxpayer is generally required to recognize accrued interest for the taxable year all the events have occurred that fix the right to receive such interest; the amount can be determined with reasonable accuracy. The ruling went on to say, "Accrual of income is not required when a fixed right to receive arises if there is not a reasonable expectancy that the claim will ever be paid."

Past rulings addressed situations where no payments were made on the loans, nor were there reasonable expectations of repayment. The 2007 ruling introduced tax nonaccrual standards, stating the "uncertainty as to collection must be substantial," a requirement applied loan by loan.

A key factor in the 2007 revenue ruling is the taxpayer's reasonable expectation that the borrower will **continue** to make some payment on the loan and, as such, will require continuing accrual of interest regardless of the regulatory requirements.

To recognize substantiation of uncollectible interest, the IRS introduced a revenue procedure that used a loan-by-loan facts and circumstances methodology. When it proved administratively burdensome and impractical, it introduced a "safe-harbor method of accounting" that works like this:

**A.** Determine for each taxable year, the amount of uncollected interest for which payment is reasonably expected

- B.** Determine the total payments the bank received on loans (including principal and interest) during the five taxable years immediately preceding the taxable year
- C.** Determine the total amounts due and payable to the bank on loans during the same five taxable years
- D.** Multiply A times the recovery percentage ( $B/C - B/C$  cannot exceed 100%)

The revenue procedure works like this:

- ▶ Uncollected interest = \$51,600
- ▶ Total payments received on loans = \$73,048,313
- ▶ Total payments due and payable during this same period = \$74,900,705

Under the safe harbor method, the taxpayer is not required to recognize \$1,276 of interest during the taxable year. The bank expects to recover interest in the amount of  $(\$51,600 * (\$73,048,313/\$74,900,705))$  \$50,323. ■

## Electronic statements: benefits, risks . . .

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If the consumer fails to do so, it may preclude him/her from asserting a claim against your institution. But what happens if *you* fail to provide the periodic statement to the consumer?

### Follow letter of the law

To send disclosures electronically, consumers must first consent to this method of delivery. To this end, the financial institution is responsible for providing consumers the required E-Sign disclosure statement, which must meet the specific requirements of Section 101(c)(1) of the E-Sign Act.

Under the E-Sign Act, consumers are required to consent in a prescribed manner, *i.e.*, "consumer consents electronically, or confirms his or her consent electronically, in a manner that reasonably demonstrates that the consumer can access information in the electronic form that will be used to provide the information that is the subject of the consent...."

If this procedure is not followed in the prescribed manner, the electronic periodic statement could be considered undeliverable from your institution to the consumer.

If this happens, the consumer's liability for not informing you of any unauthorized or fraudulent transactions could also be eliminated, leaving your institution with an expensive tab. This is especially true as the length of time grows between the undeliverable electronic statement and the last paper statement the consumer received.



### Avoid worst-case scenarios

Carefully review the process your financial institution uses to provide consumers electronic periodic statements. To comply with the requirements of the

E-Sign Act:

- ▶ Confirm the E-Sign disclosure contains all the required information, including a clear statement of the hardware and software requirements consumers must adhere to.
- ▶ Confirm your consent process is electronic and "reasonably demonstrates the consumer can access information in the electronic form that will be used to provide the information that is the subject of the consent."
- ▶ Have and enforce a process for confirming consent before you cease ground delivery of paper statements.
- ▶ Resolve problems with your consent process by requiring re-consent from affected consumers.

Contact your BKD Financial Services Group advisor for more information or for help making the transition to paperless commerce. ■

# Defining the S corporation family

by Gary Genenbacher  
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A subchapter S election generally results in a single level of taxation. An eligibility requirement for electing S corporation status limits the number of shareholders to 100. "Members of a family" are treated as one shareholder for purposes of this test. The following defines the often misunderstood "members of a family," and includes some key dates for this determination.

A husband and wife (and their estates) and all members of a family (and their estates) are treated as one shareholder when determining the total number of shareholders. This definition appears straight forward. An S corporation may determine that counting mom and dad and their three children would allow it to treat five shareholders of record as one. But digging deeper into the definition of "members of a family"

is more complicated. This definition was introduced several years ago.

Members of a family include a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant. Having a degree in genealogy is a plus when reviewing this rule.

A person is not a common ancestor if, on the applicable date, the individual is more than six generations removed from the youngest generation of shareholders who would be members of the family.

The applicable date is the latest of the date the election to become a subchapter S corporation is made, the earliest date a family member holds stock in the S corporation, or October 22, 2004. The sixth-generation limitation applies only on this applicable date.

Six generations should include all common ancestors underneath the great-great-great-grandparent of the youngest generation. Literally, hundreds of shareholders could be counted as one for purposes of the one hundred shareholder limit. Treating these shareholders as one only applies to the counting of shareholders. Each shareholder is still responsible for his/her individual taxes and each must consent to the S election. ■



## Mark Your Calendar

At 10 a.m. Central time, June 12, Kathy Smith and Kelly Earls

with Bank Compensation Consulting will present a free one-hour webcast: **Don't Train Your Competitors Next CEO.** This webcast outlines the importance of a properly designed incentive compensation program to help you reward performance, retain your

key executives and increase the profitability of your bank. Register at [bkd.com/webcast](http://bkd.com/webcast).

BKD will exhibit at Booth No. 12 at The Finance & Accounting Forum for Financial Institutions. June 22-24, 2008, Royal Pacific Resort, Orlando, Florida. BKD partners Angela Morelock and Kraig Ritter are also presenters at this conference.

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