

POSSIBILITIES

INSIGHTS FOR THE FINANCIAL INSTITUTIONS INDUSTRY

JULY 2011

Conversation With Chuck Johnson

Possibilities recently sat down with a leader in the banking industry, Charles (Chuck) Johnson, Jr., to hear about his personal history in banking, his role with the Minnesota Bankers Association (MBA) and his thoughts on where the industry is headed.

POSSIBILITIES: You have a rich personal history in banking. Can you tell us a little of your story?

Johnson: Three generations of my family have been involved in banking in the Fountain-Chatfield area—that's more than 100 years of service to our communities! Root River State Bank is the oldest bank in Minnesota, formed in 1856 with \$126,000 in starting capital. First State Bank of Fountain was established in 1901 with just \$12,000 in capital; it is the oldest business in Fountain.

I began my banking career at Root River State Bank, Chatfield, in 1978. I worked summers while going to high school and college. I started by cleaning the storeroom. Eventually, I moved upstairs where I filed checks and waited on customers in the drive-up. I continued working my way through bookkeeping and the teller area. On June 1, 1984, I began full-time employment at Root

River State Bank in lending. I was elected to the Board of Directors in 1985, and was named president and CEO in 2006. In 1987, I was elected to the Board of Directors of The First State Bank of Fountain, and became an employee of the bank in 2006, when I was named president and CEO. At age 49, I have been involved in the banking industry in some fashion for 33 years!

POSSIBILITIES: What are your expectations as chair of the Minnesota Bankers Association?

Johnson: The MBA is ready, willing and able to assist its membership in facing the various challenges presented to the banking industry. As a proven leader, the MBA is the best, single source to ensure a continued, vital financial industry. The MBA provides assistance in many ways, including advocacy, education and member services. My appreciation for the MBA has grown over the years to the point where now I believe it should be an obligation for bankers to be involved on some level. At first, I thought the MBA was there to provide our bank with a means to obtain health insurance. I dipped my toe in the water of various committees and quickly realized

Chuck Johnson—continued on page 6



ABOUT CHUCK JOHNSON

Charles (Chuck) M. Johnson, Jr., is president of Root River State Bank (Chatfield) and The First State Bank of Fountain, and the 2011-12 Minnesota Bankers Association chair. Chuck is a member of the Chatfield Commercial Club, Chatfield Lions Club, Chosen Valley Community Foundation Treasurer, and a board member of the Honors Choirs of Southeast Minnesota. He has also served as Treasurer of the Chatfield Rotary Club. His past MBA involvement includes Board Treasurer, Group Insurance Committee Chair, District 1 Board representative, ISI and EBT Board member, and chair of the Annual Meeting Planning/Bank Management Task Force.



inside

2

Evolution of Internal Audit

3

Troubled Debt Restructuring:
Solving the Identification Mystery

4

Strategic Planning Q&A

7

The Directors' Corner:
Serving on a Loan Committee

8

Communities First Act
Introduced to House



CPAs & BUSINESS ADVISORS

Evolution of Internal Audit

Regardless of the shape or form that internal audit takes in your institution, the internal audit function should be independent of the operations area under audit.



Internal audit is defined as an independent, objective process designed to evaluate and improve the effectiveness of an entity's risk management program and its internal controls. Currently, a financial institution's internal audit function takes one of several forms: 1.) The entity may completely outsource its internal audit function to an external audit firm. 2.) The entity may hire an internal auditor to specifically dedicate his or her time to auditing the controls of all departments. 3.) The entity may take a "team approach," where its employees audit the work of other employees in other departments. Or, the entity may vary one of these approaches.

Although the picture of the internal audit department may look quite different from one entity to another, internal audit has always served to test the internal controls in place. In the past, the traditional "tick-and-tie" approach to internal audit served entities well and included procedures such as reconciling, balancing and cash counts. But often, the internal audit plans did not address many key areas or aspects of the entity where significant risks to loss exposure existed. In today's changing environment, many internal audit programs have evolved into using a risk-based approach when determining the internal audit plan and audit program.

The risk-based approach begins with the preparation of a risk assessment, which assesses the entity's risk in major areas, such as credit risk, liquidity risk, interest rate risk, and legal risk through inquiries, observations, and the use of questionnaires and checklists. The risk assessment is the basis for developing an internal audit plan that effectively controls, detects and mitigates the risks identified during the risk assessment process. The audit is also based on the level of a particular internal area's risk determined through the risk assessment—some areas, such as loan operations or information technology may be considered high risk, and some areas, such as vault cash and prepaid expenses, may fall into the low risk category.

The resulting internal audit plan for a high risk area should be much more thorough, deeper and wider than procedures completed for a low risk area.

Because of the change to this risk-based approach, internal auditors will find themselves involved in a different manner than in the past. For example, in a higher risk area, such as loan operations, internal auditors should incorporate testing of compliance with the entity's loan policy, loan information presented to the Board of Directors or Supervisory Committee, and loan presentations to loan committees. Traditionally, internal audit plans have not dealt with many higher risk areas, including policy content and compliance, in carrying out the "tick-and-tie" audits of the past.

Regardless of the shape or form that internal audit takes in your institution, the internal audit function should be independent of the operations area under audit. The culmination of an internal audit should always result in a report directly to the Audit Committee, Board of Directors or Supervisory Committee. This can help the internal audit function remain independent and objective in its evaluation of the entity's risk management program. ■



CONTACT

Katie Wayne, CPA
Manager
507.386.6283
kwayne@eidebailly.com



CONTACT

Joe Willaert, CPA, CFE
Partner
507.386.6256
jwillaert@eidebailly.com

Troubled Debt Restructuring: Solving the Identification Mystery

Many financial institutions struggle to determine when they have a loan that meets the guidelines for troubled debt restructuring (TDR). Because of the diversity in practice, and with financial institutions grimacing over whether they have a TDR or not, in April 2011, FASB issued Accounting Standard Update (ASU) 2011-2 to provide additional clarification in determining if a loan restructure is a TDR. While FASB promoted this as a clarification, the use of the term “clarification” may be overreaching. Before discussing the clarification guidance provided by FASB, it is important to understand the basics for determining when a restructured loan might be a TDR.

There are essentially two requirements that must be met for a restructured loan to be a TDR: 1) There must be a concession and; 2) The debtor must be experiencing financial difficulty. While on the surface these requirements seem straight-forward, implementation becomes much more difficult. The question is, when has a concession been granted, and when is the debtor experiencing financial difficulty? What follows is a summary of the guidance regarding concession and financial difficulty.

Concession

A concession is granted when, in the normal course of the lending relationship, the creditor has given something up due to economic or legal reasons that he/she would otherwise not do. The concession can be a single item or a combination of items, but will generally consist of:

- Extension of terms, such as longer amortization periods or maturity dates beyond normal lending practice for a similar loan.
- Interest rates below normal for new debt considering the risk involved.
- Forgiveness of accrued interest or principal amounts.
- Receipt of collateral or a financial interest in satisfaction of debt that is less in value than the outstanding debt.

Whatever form the concession takes, the main purpose of granting the concession is to increase the probability of improving the financial institution’s position for obtaining more funds in the future. If this were not the case, there would be little incentive for the financial institution to grant a concession. In the clarification update on TDRs, the following items regarding concessions were added:

- If the debtor has a market interest, it is not sufficient to prevent TDR treatment.
- If the rate declines, that does not automatically mean a concession has been granted.

- A temporary or permanent increase in the rate cannot be presumed to be above the market rate.
- A debtor who does not have access to funds at a market rate with similar risk characteristics as the restructured debt may indicate a concession.
- The creditor has restructured the loan because it does not expect to collect all amounts due, including interest accrued at the original contract rate.

Financial Difficulties

Prior to the recent clarification, there was limited guidance as to when a debtor experienced financial difficulty in order to satisfy the second requirement to trigger the TDR classification. With the issuance of the clarification guidance, the following items were provided:

- The debtor is currently in default.
- Without the concession, it is probable the debtor would be in default in the near future.
- Based on estimates and projections using current information, the debtor will be unable to service any of its debt, including interest and principal, according to the original terms of the loan.
- It is probable in the foreseeable future that the debtor will default on the loan, even though they are current.
- There is substantial doubt about the debtor’s ability to survive, as a going concern.
- The debtor is in the process of filing bankruptcy.
- Without the concession, the debtor cannot obtain funds from other sources.

Determining if a restructure loan qualifies as a TDR can be an exercise in frustration because there is a fair amount of subjectively involved, and the boundaries can be somewhat blurred. It is expected with the additional guidance provided by FASB, and with the recent update in the call report instructions for TDRs dated March 31, 2011, that financial institutions will find it less difficult in determining if a loan restructure qualifies as a TDR. Regulators are looking for restructured loans that should be classified as TDRs, so it is critical that financial institutions proactively and properly identify TDRs. ■



CONTACT

Bruce Richter, CPA, CRE, CIA, CMA
Senior Manager
507.386.6255
brichter@eidebailly.com

Strategic Planning Q&A



With all the recent regulatory changes and uncertainties, it's important that bank management have defined future business model objectives. This requires a mindset that needs to be embraced by the organization as a whole, not just upper management.

In an economic downturn, our instinct is to hunker-down and weather the storm. For financial institutions, this may include cutting marketing or planning expenses. However, this is the prime time to develop a detailed strategic plan. Strategic planning is not just for “big” banks. It's vital for all financial institutions to look critically at their operations and strategy. Banks that plan will be better poised to make a noticeable recovery once the economy improves, gain market share and increase shareholder return. Possibilities recently sat down with members of our Financial Institutions group to learn their insights about strategic planning.

Panelists

Linda Koerselman, CPA | Partner

Don Johnson, CPA | Partner

Dana Ereth, MBA | Principal

Tim LeClair, CPA | Partner

Why is strategic planning more important now than ever?

Linda Koerselman: In a challenging economic environment, coupled with a changing and expanding regulatory environment, strategic planning is a process that bank boards and management teams are reviewing with renewed focus. This may be due to the fact that regulators are recommending and/or requiring some banks to develop or update their strategic plans. However, most banks recognize strategic planning needs to be current and meaningful in order to respond to changing markets, the economy and pending regulations. Most boards and management groups wish to be in control of the bank's destiny, and strategic planning is necessary for that to happen.

Don Johnson: With all the recent regulatory changes and uncertainties, it's important that bank management have defined future business model objectives. This requires a mindset that needs to be embraced by the organization as a whole, not just upper management. In order to capitalize on opportunities in the future, a bank cannot apply a wait-and-see approach.

Complacency is not acceptable. Banks must generate a vision and position to capitalize on opportunities as they arise.

Are you finding more banks conducting strategic planning sessions because of regulators?

Don Johnson: Yes, but I am also having discussions with banks that are just feeling pressure. We hear, “What are we going to do to generate income and expansion to survive in the new banking regulatory controlled environment—when it hasn't yet been totally defined?” It is positive that organizations are being proactive to recognize that they cannot just sit back and wait for the dust to settle. Instead they must attempt to address the current environment and start planning for the future.

Dana Ereth: Also, most enforcement actions will require some type of “strategic” planning, which will include board of directors and management assessments.

When banks conduct strategic planning, is there a defined process they should follow?

Tim LeClair: Every strategic planning process will likely be different because of the makeup of the participants. However, most processes will involve, to some degree, a review of external environmental factors, a review of internal environmental factors, agreement on a mission statement and/or vision, identification of strategic goals, and the development of strategic initiatives to achieve the strategic goals (including identification of personnel to champion the initiative and timelines). External environmental factors include such things as your geographic market, competitors, regulatory environment and technology. Internal environmental factors include organizational structure, current operations and current bank resources (personnel, funding, etc.).

Linda Koerselman: Strategic planning is different for each bank, but most will include similar components, such as mission statement,

core values, SWOT (strength, weakness, opportunity, threat) analysis, financial planning, strategic goals with assigned responsibility and timeline development, profitability planning, succession planning (management and board level), capital contingency planning, technology planning, liquidity planning, risk management planning, expansion planning, and product and services planning.

Who should be involved in the strategic planning process?

Linda Koerselman: Generally speaking the board and the bank's management team should be included in strategic planning. Input from bank employees may be solicited through a questionnaire, so their thoughts may also be shared. I believe the directors' input is extremely important in these meetings because of their backgrounds in other businesses or industries; their thoughts and experiences are always appreciated by management. In addition, as part of corporate governance, the board has responsibility to ensure strategic planning occurs and a sound strategic planning document is approved.

Tim LeClair: This will vary from bank to bank, but typically the strategic planning team will include representatives of the board of directors and key management executives of the bank. In small bank organizations, it is not uncommon to have representation of the bank's owners on the strategic planning team. It is important that the bank's leaders have sufficient input in the process to take ownership of the plan and provide a unified focus for future operations.

Should banks develop both short- and long-term goals or a specific timeline?

Don Johnson: Yes. Short term goals achieve results as stepping stones to meet long-term organizational objectives. The strategic planning process is ongoing, always being fine-tuned in order to obtain the vision of the organization.

Linda Koerselman: Generally, about five years ago, most strategic plans looked out over a five-

year period—sometimes longer. Since 2008, around the time the economy began to struggle and the economic crisis ensued, banks began to focus on shorter periods, with the upcoming 12 months being the time of greatest focus.

Dana Ereth: Keep in mind, the business environment changes rapidly and will affect a bank's long-term financial goals. It's important to develop a specific timeline for addressing and prioritizing goals.

How should bank leaders communicate a defined strategic plan to employees? Is it important for bank management to share with employees the bank's plan, vision and direction?

Don Johnson: Communication is extremely important. Without communication, the strategic plan will never be fully implemented. It takes ownership at all levels in an organization in order to reach the vision. A successful strategic plan will become a mindset that becomes part of the culture of the organization. Communication of the plan should be ongoing with genuine passion that defines how, why and the benefits to be generated by implementing the organization's strategic plan.

Dana Ereth: Communication with the public is also important, given the current negative media coverage of the industry.

How will a bank carry out its plan? Who's accountable?

Dana Ereth: Ultimately, the board of directors is accountable, but responsibility also lies with the chief executive officer as the visionary for the bank. Goals should be prioritized and delegated to appropriate individuals with accountability.

Tim LeClair: The strategic plan should be a living document, in that it should be referred to frequently, and impact decisions made in the day-to-day operations of the bank and the management of bank personnel. At some level, everyone is responsible for the achievement of the strategic plan. While strategic initiatives will have champions directly responsible for the achievement of the initiative, bank personnel and departments should have goals and objectives that will assist in achieving various strategic initiatives.

How should an existing strategic plan be evaluated?

Linda Koerselman: An important part of strategic planning is a review of the prior year's action items. Were they completed? Were the results expected? If an action item was not completed, evaluate why not. During the current strategic planning process, the action plans should each have a timeline and team members assigned for accountability. Don't let the strategic plan get old and cold. The board, or strategic planning committee that reports to the board, should meet periodically to review the progress of the action plans.

If you have questions about strategic planning, contact your Eide Bailly representative. To view the extended interview, please visit our website at www.eidebailly.com/industries/financial-institutions. ■

Chuck Johnson—from page 1

the MBA is much more. While the MBA keeps us informed and is a wonderful resource, for me, networking with other bankers has proven to be the most beneficial aspect of membership. Given the very private nature of our business, bankers can't just converse about their work with everyone. The ability to speak with another person going through many of the same challenges is priceless. The MBA provides this outlet and, as chair, I hope to further the MBA's objectives for future generations.

POSSIBILITIES: How do you feel your experience will help you in your role as chair of the MBA?

Johnson: Throughout my career, I've had experience in many aspects of banking, including customer service, lending and inspecting livestock and machinery. I understand how important it is to be a well-rounded banker; I believe I'm a better, more compassionate banker because of my exposure to many areas. The MBA is a one-stop, complete package for training, education programs, legislative advocacy, personal growth, insurance, etc. They provide virtually all of the tools to foster personal and professional growth. In my role as chair, I can share how I have benefited first-hand from the MBA's offerings, and encourage other bankers to take advantage of this organization's services.

POSSIBILITIES: What do you see as the major issues faced by community banks today?

Johnson: *The interchange issue* – We're concerned the government is trying to regulate the amount a bank can charge. There has to be some cost to processing. As it is, we get a very small percentage. If it is further reduced, for smaller community banks, this may significantly impact revenue.

Predatory loan pricing – Recently, Farm Credit Services has been offering loans below market rates—sometimes as low as 2-2.5 percent below market. As a community bank in a rural, farming area, we compete for customers. I don't mind competition—so long as we're on equal footing. Farm Credit Services was created with certain competitive advantages, but specifically, they are not allowed to do any predatory pricing. They are breaking their own rules. With this unfair

advantage, I can hardly blame my customers for considering doing business with Farm Credit Services. This issue is being actively examined by the MBA on behalf of its members.

Industry image – Thankfully, I believe most people differentiate community banks from the Wall Street banks. Unfortunately, we all get thrown together in generalizations, and bankers have gotten a bad rap.

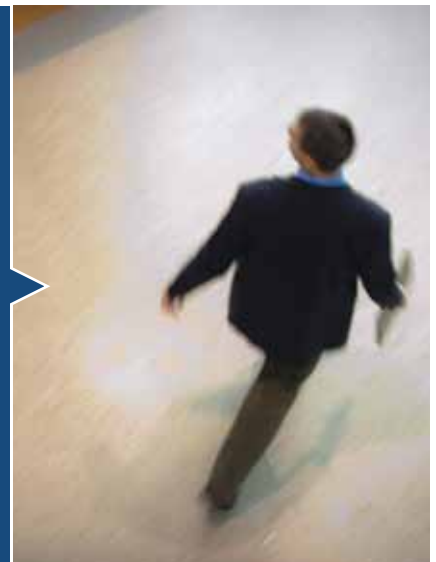
POSSIBILITIES: How do you see increased regulatory demands impacting community banks?

Johnson: Regulators have proposed hundreds of pages for implementation of Dodd-Frank. For a community bank, sometimes I feel like you must be an attorney just to muddle through everything. I understand the need for regulations; the problem is, for community banks, a lot of these regulations have “carve out” provisions, wherein certain parts don't apply, resulting in a lot of “gray” areas. Then, when examiners come in, they determine if/what we should be following. We spend a lot of time, effort and expense interpreting the regulations. The more time we spend on this, the less time we devote to more important areas, like lending. At some point it becomes too much. With smaller banks, employees wear a lot of “hats” (i.e., one of our lenders is also our compliance officer), but with compliance so overwhelming, it's hard to keep up.

The Consumer Financial Protection Bureau is the “watchdog” that is supposed to protect customers, and fix and prevent the problems that have happened in the recent past. Unfortunately, their focus is misguided—they spend too much time on those who follow the rules, rather than those who don't. It's a flawed concept. I expect the regulatory burden will continue to worsen, and impact the cost of doing business. ■

Special thanks to Chuck Johnson for taking the time to talk with *Possibilities*.

Throughout my career, I've had experience in many aspects of banking, including customer service, lending and inspecting livestock and machinery. I understand how important it is to be a well-rounded banker; I believe I'm a better, more compassionate banker because of my exposure to many areas.



THE DIRECTORS' CORNER

Serving on a Loan Committee

Many times, a director is asked to serve on a bank's loan committee. It's important to recognize that serving on a loan committee comes with significant responsibility, as well as a time commitment.

The loan committee's purpose is to oversee the credit risk management of the bank. This process begins with loan committee members—they review, revise and approve the internal loan policy. The loan policy should be consistent and aligned with the overall risk tolerance of the bank. It should also describe the role of the loan committee. For example, it should address what loans the committee will be responsible for approving, the committee's responsibilities related to reviewing performance of the loan portfolio, and the role of the committee in guiding strategies for meeting the bank's lending goals.

Given that the loan committee is usually tasked with approving loans with certain risk profiles, individuals serving on a loan committee should have a thorough understanding of the loan policy and intimate knowledge of the bank's lending process.

As a committee member, an individual can expect regular loan approval meetings. These meetings may be as frequent as weekly. Loan committee members are expected to adequately prepare for the meetings. To prepare, loan packages containing summaries of the loan requests are sent out at least 24 to 48 hours prior to the meeting. Committee members should become familiar with loan requests so they may develop an objective opinion as to whether the credit is an appropriate risk for the bank to assume. Members should also develop tough direct questions for the loan officer at the approval meetings.

The loan requests should, at a minimum, include a high level financial summary, a description of the strengths and weaknesses of the credit, global cash flow analysis, collateral analysis and a description of guarantors. This information will allow committee members to develop their own conclusions as to the creditworthiness of the potential borrower. Loan committee members will ultimately be asked to

vote to approve the loan presented. The committee member should vote with conviction, as they are supposed to provide an objective third-party review prior to final loan approval.

The committee member should have a thorough understanding of the loans they are approving, and be cognizant of the fact that the FDIC has brought lawsuits against directors of failed banks. This would include directors serving on loan committees. Reasons for the suits involved directors approving loans they knew or had reason to believe were improperly underwritten. This may include lending to a borrower without obtaining adequate financial information, where the collateral was obviously inadequate, or where the borrower clearly lacked the ability to pay.

In addition to approving loans, members of the loan committee will be expected to review and monitor the credit performance of the loan portfolio. To do this, the committee will expect management to provide various loan reports on a periodic basis. Such reports may include portfolio concentrations, loans by various risk-rating, non-performing assets, charge-offs, past-due and non-accrual loans, and analysis of the allowance for loan loss.

Finally, members of the loan committee will be asked to review the strategies to achieve the lending goals for the bank and make the appropriate recommendations to the Board of Directors and management.

Serving on a loan committee of a bank is one of the most important roles a director may be asked to perform. The decisions made by members of the loan committee will ultimately influence the overall success of the bank. ■



CONTACT

Al Nolte, CPA
Senior Manager
952.918.3580
anolte@eidebailly.com



4310 17th Ave S
PO Box 2545
 Fargo ND 58108-2545

RETURN SERVICE REQUESTED

POSSIBILITIES is produced and published by Eide Bailly and distributed with the understanding that the information contained does not constitute legal, accounting or other professional advice. It is not intended to be responsive to any individual situation or concerns as the contents of the publication are intended for general informational purposes only. Readers are urged not to act upon the information contained in this publication without first consulting competent legal, accounting or other professional advice regarding implications of a particular factual situation. Questions and information for publication can be submitted to your Eide Bailly representative or to the editors of the newsletter. Copyright 2011

To view this and previous issues of **POSSIBILITIES**, visit www.eidebailly.com/publications

Managing Editor: Liz Stabenow
Assistant Editor: Bonnie Oelschlager
Send comments to:
possibilities@eidebailly.com

**An Independent Member Firm
of HLB International**

www.eidebailly.com

Communities First Act Introduced to House

On May 3, 2011, H.R. 1697, the “Communities First Act” was introduced to the U.S. House of Representatives by Rep. Blake Luetkemeyer of Montana. This proposed legislation contains several favorable provisions for community banks, including:

- Ability for community banks to amortize losses on real estate loans and other real estate owned over a 10-year period for regulatory capital purposes;
- Extends the five-year tax net operating loss carryback provision for community banks through 2011 losses;
- Relief from the inhibitions of utilizing tax net operating loss carryforwards for community banks when raising new capital;

- Allows S corporations to have 200 shareholders, have IRA shareholders and issue preferred stock; and
- Provides a tax credit of 20 percent of taxable income (up to a maximum credit of \$250,000) for C corporation community banks.

Several other favorable provisions are contained in this bill for community banks. ■

As of the date of publication of this newsletter, this legislation has not yet passed through the House.

For an extended analysis of this legislation, please see the extended article on our website, at eidebailly.com/industries/financial-institutions.com.

MARK YOUR CALENDAR

Save the date for our 2011 Bankers Seminars:

Thursday, October 27
Fargo, North Dakota

Thursday, November 3
Mankato, Minnesota

Thursday, November 17
Sioux Falls, South Dakota