

FINANCIAL INSTITUTIONS

POSSIBILITIES

*Recession Response—How is Your Bank Preparing for an Upturn?***OVERVIEW**

Over the past year, the nation grappled with a severe economic downturn. A “perfect storm” left many financial institutions crippled and vulnerable as they struggled with the evaporation of the capital markets, accentuated loan losses, and a changing regulatory environment. We are optimistic, though, that the economy will regain its strength as organizations continue to adjust. This article discusses opportunities in anticipation of an economic up-turn.

Although we believe business fundamentals are still critical for many financial institutions, we have begun to focus strategic direction on capitalizing on the opportunities available during a recession.

We know this may be difficult for banks that are still in “survival mode.” However, it is important to look past the uncertainties and prepare for the future. We know what lies ahead will not be busi-

ness as usual, as there will be significantly less financial leverage in the system and we may never return to our pre-crisis economic state.

What is certain are the opportunities that exist in a recession. At Eide Bailly, we are taking a proactive approach by working with our clients to position their financial institutions to emerge as winners in the marketplace. At the same time, we are keeping an eye on the possible challenges that still lie ahead. Namely:

- The expectations of rising interest rates and taxes
- The effects of a continued rise in unemployment in the short-term
- The pressure on declining business valuations and multiples, and
- The impact of unprecedented budget deficits, both at the state and federal levels.

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Participation Loans—New Rules Issued by FASB



If the “participating interest” fails to qualify for sale treatment, funds received are recoded as secured borrowings, resulting in the entire loan to be retained on the books and potentially exceeding the financial institution’s lending limit.

Recently, FASB issued FAS 166, which was an amendment of FAS 140, dealing with the transfer of financial assets. The direct impact of this statement affects financial institutions and how they must handle participation loan arrangements entered into after December 31, 2009. Participation arrangements prior to this date are grandfathered in. The standard creates a new term for portions of loans being sold—“participating interest.” Characteristics of a “participating interest” include:

- On the date of transfer, the “participating interest” represents a pro-rata share of the entire financial asset.
- All cash flow received from the financial asset is distributed on a pro-rata basis, based on the percentage of ownership.
- The rights of the “participating interest” holders are the same as everyone else—and do not change even under bankruptcy. The “participating interest” holders have no recourse to the selling financial institution. Servicing fees collected by the selling financial institution shall be reasonable.
- No party has the right to pledge or exchange the entire amount of the financial asset unless

all parties agree. This does not prevent the “participating interest” holders from pledging their share of the financial asset.

These guidelines essentially eliminate participation agreements issued under a FIFO or LIFO arrangement regarding payments if sale treatment is to be achieved. In some of the participation loan agreements, there are options that can be selected by the seller and the buyer; the options selected must now be in compliance with the new standard in order to get sale treatment of a portion of the loan. If the “participating interest” fails to qualify for sale treatment, funds received are recoded as secured borrowings, resulting in the entire loan to be retained on the books and potentially exceeding the financial institution’s lending limit. Certain regulatory agencies are treating the impact of this new standard differently and you will need to inquire with your respective regulator. ■



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Viruses and Malware—Are You Protected?

OVERVIEW

The last several years have seen an exponential increase in the number of new viruses. Currently, nearly 600 new viruses appear each month—that's 20 new viruses each day. These new viruses are becoming increasingly sophisticated in the ways in which they spread and infect machines. Viruses now exist which can infect program files, Word documents, Excel spreadsheets, Java applications, Access databases, batch scripts and more. At the same time, the Internet's increasing popularity and the steady adoption of "always on" broadband technologies has allowed viruses to spread quickly. This article reviews virus and malware protection.

The term virus is often used as a generic reference to any malicious code. However, not all malicious programs or codes are viruses. The correct term is malware—short for malicious software. Due to the many facets of malicious code or a malicious program, referring to it as malware helps to avoid confusion. Viruses continue to occupy a majority of all known malware to date. The other major types of malware are Trojans and worms.

In order to determine the security needs of your financial institution, it is important to understand the possible points of vulnerability in the computing environment. By establishing the common entry points, you can determine where anti-virus software should be deployed. These entry points include e-mail, the Internet and portable media, including CDs and DVDs. With these potential entry-points identified, the three areas to deploy anti-virus software are through personal computers, your Internet gateway and on servers.

Scanners remain the most popular type of anti-virus software used today. They contain detection/disinfection information for all known viruses. They are intuitive to use and capable of identifying a virus (i.e., ABC.doc is infected with the 'XYZ' virus). The main disadvantage of scanners is that they need to be kept updated with the latest virus information in order to remain effective.

The Internet, e-mail capability and other Internet tools have provided new avenues for

communication and the exchange of information, but have brought along hordes of new potential problems. Viruses and other malware-related attacks form a large part of these problems. Purchasing appropriate anti-virus software is one of the critical steps in ensuring a safe computing environment, but purchasing and installing anti-virus software is just the beginning. Administrators should ensure that software installations are kept current with the latest virus updates, and educate users to take proper precautions while using their systems.

With all the hype, it is easy to believe that having anti-virus software is all the security that a bank needs. Although anti-virus software does reduce the risk of infection, it is not foolproof. Eide Bailly takes the potential for viruses and other malware-related attacks very seriously. We utilize an enterprise-wide software solution to assist in the protection of our technology assets against these potential attacks. This includes monitoring and performing updates and centrally managing our entire infrastructure, including personal computers, our Internet gateway and servers.

Virus and malware protection is a critical component of security. We encourage you to regularly review your virus and malware protection to safeguard your bank's assets, as well as your customers' information. Through proper maintenance and security applications, your financial institution can remain virus and malware free. ■



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Distressed Banks: Reevaluate S Corporation Election

OVERVIEW

For distressed S Corporation banks and holding companies, it may be beneficial to reevaluate whether the S Corporation taxation structure is a good fit for their organization at this time.



For distressed S Corporation banks and holding companies, this cash flow crunch could be too big of a burden for their shareholders to bear. Thus, it is important for distressed S Corporation banks and holding companies to reevaluate whether the S Corporation taxation structure is a good fit for their organization at this time.

Ever since the Small Business Job Protection Act of 1996 made the S Corporation election available for banks and their holding companies, many community banks across the region have utilized this tax structure and have realized tremendous benefits from it, along with their shareholders. The S Corporation taxation system has allowed greater after-tax cash flow to be realized by shareholders, and has also played a part in increasing the shareholder value of a bank when they've decided to sell their organization. Overall, the S Corporation election has definitely been great for the community banking industry.

However, in the current challenging environment in which community banks are operating, some S Corporation banks are experiencing a decline in earnings, resulting in an inability to pay cash distributions to shareholders. No cash distributions could mean a potential cash crunch for individual shareholders when paying their tax liability on pass-through taxable income from an S Corporation. Generally, when a distressed bank holding company elects the deferral of payments of trust preferred securities interest, no shareholder distributions are allowed during the deferral period.

Another cash-flow hurdle for a holding company is the debt-to-equity ratio. If it exceeds 100 percent, Federal Reserve regulations do not allow a holding company to make cash distributions to shareholders without special approval. If a subsidiary bank has been incurring losses and not paying dividends to its holding company, it's possible that the holding company has incurred debt to inject bank capital or pay current operating expenses, while the bank losses are shrinking the holding company's equity as well. Many holding companies that may have had a very low debt-to-equity ratio a year or two ago are experiencing a much higher ratio today, as a result of subsidiary bank losses and increased borrowing.

For distressed S Corporation banks and holding companies, this cash flow crunch could be too big of a burden for their shareholders to bear. Thus, it is important for distressed S Corporation banks and holding companies to reevaluate whether the S Corporation taxation structure is

a good fit for their organization at this time. As with any decision, having a good grasp of what results to expect after an action is taken is a great aid in making an informed decision.

Mechanics of Revoking S Election

If a distressed S Corporation bank makes the decision to revoke its S Corporation election and revert back to a C Corporation for tax purposes, they can accomplish the revocation by either:

- a) Voluntarily revoking their election, whereby they file a statement with the Internal Revenue Service containing the consent of greater than 50 percent of their shareholders; or
- b) The election could be revoked by transferring a single share of stock to an ineligible shareholder, such as a foreign person.

If attempting a voluntary revocation, the effective date can only be a prospective date, not a retroactive date ... unless the voluntary revocation statement is filed prior to 75 days after the last tax year-end. For calendar-year taxpayers, this means that if the revocation statement is filed before March 15, then the revocation can be retroactive back to January 1. If not filed until after March 15, the revocation can only be effective for a date no earlier than the filing date.

For example, if an S Corporation did not file its revocation statement until April 30, that is the earliest date the revocation could be effective. The bank would then have a short-period S Corporation tax return to file for the period January 1 through April 29, and also a short-period C Corporation tax return to file for the period April 30 through December 31. Many taxpayers desire the January 1 effective date, for administrative ease and filing only one tax return for the year instead of two separate ones.

Results of Revoking S Election

Generally, the IRS requires a taxpayer to wait for a period of five years before it is eligible to reelect S Corporation status. Once a taxpayer reelects S Corporation status, the built-in gains window re-starts, and the net unrealized built-in gain is measured again as of the "new" S election

date. Thus, the built-in gains process that the S Corporation bank went through when it first made the election is effectively “relieved.”

After the revocation, the bank would effectively revert back to being taxed as a C Corporation, and would begin paying its own taxes once again. Any cash dividends paid out of the holding company to its shareholders would again be fully taxable, currently for 2010 at a 15 percent Federal tax rate. The stock basis of the shareholders’ bank or holding company as of the date of S election revocation is effectively frozen, and carries forward as their current stock basis of the now C Corporation entity.

If the bank and holding company have average annual gross receipts of greater than \$5 million, and had elected to compute their taxable income using the cash basis method of tax accounting, they would be forced to change back to the accrual method of accounting for tax purposes. This means that the large deferral that they enjoyed when the former S Corporation made the accounting change to the cash method would now “catch up” to the bank, and the C Corporation bank would effectively recognize that deferral and have to pay tax on it. If the S Corporation status is properly revoked for the holding company and the bank, this large item of taxable income would be spread over a four-year period.

A potentially positive result of the S election revocation could be the recording of a deferred

tax asset on the bank’s books. S Corporations generally did not record deferred tax assets to their balance sheets, unless they were taxed at the state level. The loan loss reserve is a deferred tax item, so there is potential for a deferred tax asset to be accrued upon S Corporation revocation, which would be a boon to Tier One capital.

There are many other factors and results to consider prior to making the decision to revoke or not to revoke for distressed S Corporation banks and holding companies. Each bank and holding company’s tax situation is unique, it is of utmost importance to discuss this issue with your tax advisor and evaluate the impact a change of this magnitude would have on your organization, and on your shareholders.

Historically, the availability of the S Corporation election has been a great option for community banks and their shareholders, but current economic conditions may cause some troubled S Corporation banks to stop and reevaluate their optimal tax operating structure. Our Spring 2010 newsletter will discuss the continued upside of operating as an S Corporation bank and holding company, even with the anticipated individual tax rate hikes looming in our future. ■

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UPDATE

The Pension Protection Act of 2006 enacted important changes regarding employer owned life insurance contracts issued after August 17, 2006. Under IRC § 101(j)(1), death benefits on life insurance contracts issued after August 17, 2006, are tax free only if certain requirements are met.

Effective June 15, 2009, the IRS released Notice 2009-48 which provides guidance on the reporting requirements for life insurance contracts issued after August 17, 2006. The notice also provides limited relief for periods prior to June 15, 2009, for employers that made a good faith effort to comply with the statutory requirements of IRC § 101(j)(1).



Audit Committee Formation for Institutions with less than \$500 Million in Assets

OVERVIEW

Financial institutions with total assets in excess of \$500 million are required to have an independent audit committee of its board of directors. The question that arises from time to time is what about those institutions with assets less than \$500 million? The 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Institutions encourages the board of directors of each institution, not otherwise required to do so, to establish an audit committee consisting entirely of outside directors.

An audit committee assists the regulatory agencies to achieve its safety and soundness objectives for an institution. To carry out this responsibility, an audit committee must identify the risk areas within an institution's financial statement and operating controls, and develop an audit plan to address those risks. Based upon the audit plan, the audit committee determines the risks to be addressed by the institution's internal auditor and those to be addressed by an external audit function. The primary responsibility of an audit committee is to provide oversight of the institution's internal and external audit functions.

The internal audit plan of the institution is approved on an annual basis to address the operational control and financial statement risk areas of the institution. Any modifications to the internal audit plan should be reviewed and approved in advance by the audit committee. The audit committee should also review all internal audit reports and related recommendations. The audit committee's duties would also include ensuring that the recommendations identified in the internal audits conducted have a timeline for resolution and subsequent reporting of the status of the recommendations.

The audit committee would also be responsible for determining the extent of the external auditing to be performed to compliment the institution's internal audit function in addressing the operational control and financial statement risk areas. Should the audit committee determine the need to compliment their internal audit function with an external audit function, the audit committee would be responsible to:

- Determine the type of external audit engagement—financial statement audit, balance sheet audit, agreed-upon procedures engagement (director's examination) or

attestation engagement of an institution's controls over financial statement preparation.

- Evaluate the external audit firm's qualifications and independence to perform the requested work and subsequent engagement of the external audit firm.
- Require the external audit firm to present the results of the requested services performed.

An often overlooked responsibility of the audit committee is to establish a mechanism, appropriate for the size and complexity of the institution, for employees to confidentially and anonymously submit concerns to the audit committee about questionable accounting, internal accounting control or auditing matters. The audit committee should also set up procedures for the timely investigation of complaints received and the retention for a reasonable time period of documentation concerning the complaint and its subsequent resolution.

The establishment of an effective audit committee should be a component of all financial institution's corporate governance structure. The safety and soundness of a financial institution is enhanced with an audit committee. Strong consideration should be given to establishing an audit committee of the board of directors if an institution has not already done so. ■



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Most executives have refined their operations over the past twelve months. Many financial institutions and business organizations, however, are finding they cannot “cut” their way out of this economic environment. Therefore, it’s important to focus on growth. Looking forward, ask yourself, how will you grow your organization in the current marketplace? The following are some of the key strategic areas of focus:

- Re-evaluate your competitive advantage. The marketplace is shifting, and what sustained you for a long time may not help you emerge as a winner.
- Use your team to re-evaluate your growth strategy, which may include transitioning existing products into current or new markets or creating new products for current and new markets.
- Executives are back on the front lines with sales. They are deal-makers (versus order-takers), problem solvers and quick decision-makers.
- Customer relationship managers are keys to success; thoroughly understand your customers’ needs and their industries’ demands.
- Bankers must become value-creators. Talking brochures no longer work; bankers need to be good listeners and problem-solvers.

- For peak performance, hire your people for their core values, but look to coach and mentor them to strengthen their personal and technical skills.
- Identify your “rising stars” and challenge them to reenergize your project teams and drive change in your organization. Use tools to identify the real issues with your teams and improve upon those areas.

Perhaps this economic crisis will turn around with less negative impact than many expect. If you apply the “perfect storm” fundamentals to your organization and go after opportunities in a disciplined, strategic way, the worst that may happen is that you emerge as a stronger leader in your community. ■



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Mileage Update!

Effective January 1, 2010, the IRS business mileage reimbursement rate will change from 55 cents per mile to 50 cents per mile.

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MARK YOUR CALENDAR

Thank you for attending the 2009 Bankers Seminar! We enjoyed providing this complimentary seminar to regional bankers—and getting better acquainted with you.

Save the date for our 2010 Bankers Seminars:

Thursday, October 28—Mankato
Thursday, November 4—Fargo
Wednesday, November 10—Sioux Falls

We appreciate your comments and suggestions. If you would like to provide feedback or share your thoughts for future seminars, please complete our survey online at www.eidebailly.com/bankersseminar.

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February 9—Minneapolis
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February 11—Bismarck
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www.eidebailly.com/seminars.aspx

Hope to see you there!