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Accounting for financial instruments

Proposal foretells major impact on banks

The Financial Accounting Standards Board (FASB) is considering proposed changes in accounting for financial instruments and plans to adopt final standards by June 2011. If adopted, the proposal — which calls for most financial instruments to be measured at fair value — would have a significant impact on the way banks account for loans, deposits and investments. It also would change the way banks measure credit impairment and calculate loan loss reserves.

FASB hasn't yet determined the effective date of the new rules, though the proposal calls for an effective date no earlier than Jan. 1, 2013. Nonpublic banks with total consolidated assets less than \$1 billion would have four more years to comply.

A fair value approach

Here are some key components of FASB's 218-page exposure draft, which also would revise rules related to derivatives and hedging activities:

Loans. Under current rules, various debt instruments are accounted for in different ways. Loans held for collection, for example, usually are measured at amortized cost, while loans held for sale may be valued at the lower of cost or fair value. The proposal calls for most loans to be measured at fair value. For loans held for collection, there would be reconciliation from amortized cost to fair value.

If adopted, the proposal would have a significant impact on the way banks account for loans, deposits and investments.

Initially, banks would recognize loans at their transaction price, which approximates fair value. In later reporting periods, loans held for collection would be measured at fair value, with changes recognized in



other comprehensive income (OCI). Changes in the fair value of loans held for *sale* would be recognized in net income.

By requiring banks to report changes in the fair value of loans held for collection in OCI, FASB says, the proposal wouldn't have a dramatic impact on net income. Net income would only reflect changes arising from interest accruals, credit impairments, and realized gains and losses.

Deposits. To provide "symmetry" between accounting for financial assets and accounting for the liabilities that fund them, the proposal calls for certain financial liabilities to be measured at fair value. Noncore deposit liabilities would be measured at fair value, with changes recognized in net income.

Core deposit liabilities, however, would be measured by the "present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits," with changes reported in OCI. This approach would better reflect the economic benefits of this lower cost, stable funding source, according to FASB.

Credit impairment and reserves. The proposal would eliminate the “probable” threshold for credit impairment — that is, banks would no longer wait until a credit loss is probable before recognizing an impairment. As a result, impairments would be recognized earlier than they currently are.

The proposal also would modify the “incurred loss” model, under which banks don’t recognize credit impairments or increase loan loss reserves unless there are indications that a loss has occurred as of the financial statement date. The new model would require banks to consider past events and existing conditions and their impact on the collectibility of a loan’s future cash flows.

Although the proposal calls for a more forward-looking approach, it stops short of a true “expected loss” model, as recently proposed by the International Accounting Standards Board. FASB’s proposal would require banks to assume that economic conditions at the end of the reporting period continue throughout the loan’s remaining life. An expected loss model would involve forecasting future events or economic conditions that didn’t exist on the reporting date.

The proposed model, which calculates reserves based on expected loss rates, would require banks to increase reserves earlier, affecting income and capital. Proponents of this approach believe that it would smooth reserves over time and provide a more accurate picture of the present value of future cash flows. Critics argue that it would place undue pressure on capital without allowing banks to build up a reserve cushion during good times and, like the current model, would be highly subjective.

One potential advantage of the proposed model is that it would better align a bank’s auditors, who are limited to a historic view of credit impairment, with banking regulators, who often consider

forecasts about future conditions when evaluating bank capital and reserves.

Next steps

If FASB’s proposal is adopted, there will be some time before it takes effect. But it’s a good idea for banks to start thinking about how these accounting changes will affect them.

For community banks — which typically have a significant number of loans amortized at cost — the shift to a fair value approach will create volatility on their comprehensive income statements. Banks that hold loans for sale may also experience increased volatility in net income. In addition, changes to the treatment of loan losses will cause banks to recognize those losses earlier.

Banks should assess the impact of the new standards on their accounting systems and begin planning for any necessary modifications. They also should ensure that they have the technical expertise needed to comply with more complex valuation requirements. ▲

Easier to read?

In a development related to the changes discussed in the main article, the Financial Accounting Standards Board (FASB) established new credit risk and loan loss disclosure requirements. The objective of the changes summarized in FASB’s Accounting Standards Update (ASU) 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, issued in July 2010, is to make it easier for financial statement users to evaluate:

- The nature of credit risk inherent in a bank’s or other entity’s portfolio,
- How that risk is analyzed in arriving at the allowance for credit losses, and
- Changes in the allowance and the reasons for those changes.

To achieve this objective, the new rules require banks to provide existing disclosures and a number of new disclosures on a disaggregated basis according to portfolio segment and class of financing receivable. For public banks, certain disclosures are required for reporting periods ending on or after Dec. 15, 2010. Nonpublic banks have an additional year to implement systems for tracking the data the new rules require.

How does your bank gauge loan quality?

The real estate and financial crisis highlights the need for lender quality control (QC) programs. Unless you thoroughly evaluate and monitor your loan origination and underwriting processes, you may be exposing your bank to unnecessary risk.

Recognizing this risk, Fannie Mae recently beefed up its QC policies, and Freddie Mac may follow suit. If your bank sells loans to the secondary market, it's required to have a QC program. But even if it doesn't, consider following Fannie Mae's guidelines to help ensure the quality of your loans.

The new requirements cover, among other things:

QC programs. Fannie Mae expects lenders to develop and maintain a QC program that defines the lender's quality standards and designs processes and controls to achieve those standards.

If your bank sells loans to the secondary market, it's required to have a quality control program.

Outsourcing QC. Lenders that outsource QC must establish a process to review the contractor's work and procedures and address the contractor's mortgage loan review findings. Fannie Mae also specifies the qualifications a QC contractor should possess and



the information required in the contractor's written policies and procedures.

Third-party originators. Lenders must establish written procedures for approving third-party originators, including review of the third party's financial statements and current licenses. Lenders also must perform quarterly, rather than annual, performance reviews for third-party mortgage loans.

Prefunding review. A lender's plan must include a prefunding QC review process to prevent closing mortgage loans with significant defects, such as misrepresentations, inaccurate data or inadequate documentation.

Postclosing review. Lenders must select loans for QC review within 30 days of closing and complete their

review within 60 days (formerly 90 days for review). Lenders are permitted to use statistical sampling instead of the standard minimum 10% random selection process.

Fannie Mae also is establishing a policy that requires lenders to attempt to verify owner-occupancy. The QC process also must include a review of potential red flag messages or alerts.

Reporting and audit review. Lenders must report the results of QC reviews to senior management within 30 days. They also must have an audit process to ensure

that the QC process and procedures are followed and that assessments, conclusions and findings are consistent and accurately recorded. Lenders should distribute audit results to senior management and other appropriate personnel and develop an action plan for remediation or changes to policies or processes.

Whether or not your bank sells loans to the secondary market, a solid loan QC program offers significant benefits. It can help you ensure the integrity of the data underlying your underwriting decisions, avoid fraud and spot potential problems while there's still time to address them. ▲

Small business lending

Watch out for inflated receivables

In desperate attempts to secure loans in today's conservative lending environment, some small businesses are artificially inflating their receivables on financial statements by postponing bad debt write-offs, stretching out revenue recognition cutoffs or even recording bogus sales. In other instances, small business staffs are stretched so thin that inadvertent errors in recording receivables are being made.

Fortunately, bankers who conduct extra due diligence on receivables can sort fiction from fact and errors from accuracy.

Expenses should vary

Banks routinely monitor receivables from year to year and compare receivables to sales with the days sales outstanding (DSO) ratio [(average receivables ÷ annual sales) × 365 days]. But various expenses — such as the cost of postage — also should change in tandem with receivables.

If such expenses are unchanging, it suggests management may be booking fictitious sales and warrants further investigation. Also be skeptical of businesses



that report significant improvements in gross margin or reduced shipping costs, especially when the DSO ratio has increased.

Concentration risks common

It's risky for a company to rely on one customer for more than 10% of annual sales. What happens if a key customer chooses an alternate supplier, strong-arms more lenient payment or pricing terms, or files for bankruptcy?

Unfortunately, concentration risks are common, especially among small businesses. So identify which borrowers suffer from concentration risk. Then keep an eye on the financial performance of their key customers and track expiration dates of any pricing commitments or exclusivity contracts.

Clues abound around year end

A business's balance sheet reports accounts receivable as of a certain date. But what happens after the accounting period ends? You can get a clearer picture of the condition of receivables by investigating how much of the balance for outstanding invoices was paid or written off, how many sales were reversed, and how many credit memos were issued within a month of year end.

Pay close attention to receivables journal entries made the last few weeks of the year. A significant increase in year end account activity suggests receivables manipulation.

Just as many receivables scams are reversed shortly after the accounting period, aggressive managers also may scramble to inflate receivables just *before* year end. So, pay close attention to receivables journal entries made the last few weeks of the year. A significant increase in year end account activity suggests receivables manipulation.

Supplemental info is a must

Financial statements provide minimal information, so ask for supplemental schedules, such as aging reports or sales decomposition reports. For example, you might ask borrowers to compare credit vs. cash sales or break down collections by salesperson.

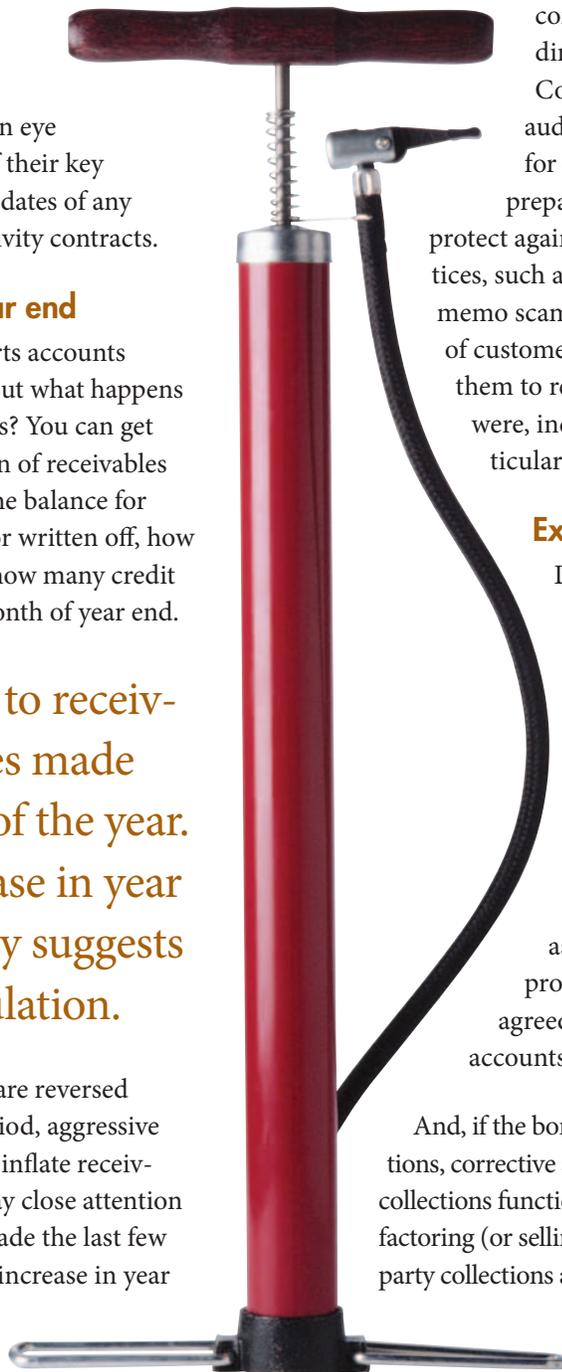
With permission, you also can contact the borrowers' customers directly to confirm receivables.

Confirmation letters — a routine audit procedure typically *not* done for compiled, reviewed or internally prepared financial statements — protect against aggressive accounting practices, such as fictitious revenue or credit memo scams. Sent to a random sample of customers, confirmation letters ask them to respond whether specific invoices were, indeed, outstanding as of a particular date.

External assistance

Due diligence is the most effective tool for detecting inaccurate or inflated receivables. If you feel, however, that procedures such as those mentioned above are too time-consuming to complete yourself — or beyond your “comfort zone” of expertise — consider obtaining professional assistance. An outside financial professional can conduct specific agreed-upon procedures that target accounts receivable.

And, if the borrower suffers from poor collections, corrective action might include outsourcing collections functions to a third-party administrator, factoring (or selling) stale receivables to a third-party collections agency at a discounted rate, or charging interest on late payments. ▲





FEDERAL RESERVE SETS RULE ON APPRAISER INDEPENDENCE

Imposing strict appraiser independence requirements for mortgage loans or other consumer credit transactions secured by a consumer's principal dwelling is one of the key provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act affecting community bankers. Dodd-Frank amended the Truth in Lending Act to prohibit:

- Coercion or bribery designed to influence an appraiser's conclusions,
- Appraisers or appraisal management companies from having a direct or indirect financial interest in the property or transaction, and
- Lenders from making loans if they know of a violation of the above.

The amendments also mandate the payment of reasonable and customary compensation to a "fee appraiser" — that is, one who isn't a salaried bank

employee or an appraisal management company hired by the bank.

The Federal Reserve Board is implementing these provisions with an interim final rule, effective Dec. 27, 2010, that expands on Dodd-Frank. The rule, for instance, provides examples of actions that do and don't constitute unlawful coercion.

The rule also clarifies that Dodd-Frank doesn't prevent banks from using in-house staff appraisers and affiliated appraisal management companies and that employment or affiliation doesn't, by itself, create a conflict of interest. The rule establishes a safe harbor and guidance for building firewalls between the appraisal and loan production functions to prevent conflicts of interest.

An interim final rule has the full force of a final rule, but the rulemaking body will still consider constituents' comments and may revise it before issuing a final rule. Compliance is optional until April 1, 2011. ▲



SMALL BUSINESS LENDING FUND

Community banks seeking new sources of capital should consider applying to the Small Business Lending Fund. Created by the Small Business Jobs Act of 2010, the \$30 billion fund is intended to provide capital for banks to lend to small businesses and farmers. The fund will be used to purchase preferred stock or debt obligations in community banks and bank holding companies.

To qualify, your bank must have a CAMELS rating of 3 or higher and submit a small business lending plan. The maximum investment available is 5% of risk-weighted assets for banks with \$1 billion or less in total assets. For banks with more than \$1 billion in total assets (but not more than \$10 billion), the maximum investment is 3% of risk-weighted assets. ▲



P&G Associates (“P&G”) has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to national firms, P&G provides internal audit, regulatory compliance, BSA/AML, information technology and enterprise risk management review services and software. P&G is exclusively dedicated to the banking industry, providing clients with dedicated, focused and hand-held services reflective of a wide range of skills, experience and industry expertise. As a Firm, we have also been proactive in assisting our clients with the designing, implementation and testing of the internal control environment to assist management with the attestation requirement under the Sarbanes-Oxley Act.

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We believe that a significant aspect of our services is our degree of involvement and responsibility to assist management by making suggestions for improvement, keeping them informed of professional developments and by acting as an independent counsel and sounding board on general business matters and new ideas.

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