July/August 2011

Bank Notes

A timely information and idea statement

Converting Non-Earning Assets into Earning Assets

By: Brett Hartema

Financial institutions have seen significant increases in foreclosures and troubled debt restructurings in recent years as more borrowers continue to experience financial difficulty due to ongoing economic and real estate market turmoil in many areas of the United States. The accounting rules regarding Real Estate Owned (REO) and Troubled Debt Restructurings (TDRs) are complex and this article will focus on several key current issues related to these topics.

Real estate owned (REO)

Determining the amount to transfer at time of repossession

REO represents real estate acquired by an institution through foreclosure or deed in lieu of foreclosure after a borrower defaults on a loan. Accounting rules state that foreclosed real estate acquired in satisfaction of a defaulted loan should be recorded at fair value less estimated costs to sell at the time of foreclosure, which then becomes the institution's new cost basis in that REO property.

The fair value of REO will generally be derived from an independent appraisal. Due to the subjective nature of the assumptions and methodologies used in appraisals, institutions should ensure they are engaging qualified independent appraisers and implement procedures for reviewing the conclusions in the appraisal reports. Institutions should also give consideration to the age of the appraisal being used to determine the fair value at the time of foreclosure and implement procedures to obtain updated appraisals when necessary to ensure any material changes in the market are properly reflected in the value. Updated appraisals should be obtained more frequently during times of real estate market turmoil when rapid changes in market values are likely.

Accounting for further changes in value and holding costs

After the REO property's new cost basis has been established and recorded, accounting rules require an ongoing analysis of the current fair value less estimated costs to sell compared to the cost basis. At the end of each reporting period, institutions need to consider whether the fair value has deteriorated further during the period, in which case that deterioration must be charged to current period expense. Alternatively, if the fair value has increased during the period, the cost basis remains the same as no gain is recorded until disposition.

Other costs incurred by institutions while holding the REO property such as maintenance costs, property taxes and insurance are generally required to be recorded as current period expenses as they are incurred. While most holding costs are required to be expensed, certain costs may qualify to be capitalized when they result in permanent improvements that add value to the property. For example, if an institution forecloses on a partially completed residential subdivision development, costs incurred by the institution to complete the development while the property is in REO may be capitalized.

Gain recognition on sales of REO properties

A key element to consider related to gain recognition when an institution sells an REO property is whether the institution is providing financing to the buyer. If the selling institution is not providing financing to the buyer, then any gain on the sale is fully recognized immediately. In instances where the selling institution is providing financing to the buyer, the amount of gain recognized will primarily depend on the size of the buyer's down payment. Accounting rules outline six different methods for gain recognition depending on the size of the down payment and other criteria.

In general, accounting rules state that in situations where the new buyer is providing only a minimal down payment, the bank still retains risk and as such, is not allowed to recognize the full gain on a sale until the borrower has assumed the risk through an established history of making payments. Accounting rules related to gain recognition on real estate sales are relatively specific and should be closely analyzed by institutions for each sale where financing is provided to the buyer. Regardless of whether the selling institution provides financing to the borrower, losses on sales are recognized immediately.

Troubled debt restructurings (TDRs)

Troubled debt restructurings are currently a hot-button topic for financial institution regulators and auditors alike. In general, a TDR is deemed to have occurred whenever a loan modification for a borrower in financial difficulty results

Converting Non-Earning Assets, continued on page 3

HARDING, SHYMANSKI & COMPANY, P.S.C.

Certified Public Accountants and Consultants

An Independently Owned Member

MCGLADREY ALLIANCE

©2011 RSM McGladrey, Inc. All Rights Reserved. Used with Permission.

Bank Notes

Cloud Computing for Financial Institutions

By: Loras Even and Aaron Donaldson

Many institutions may be familiar with the term cloud computing, but may not understand the concept, or that they have been using an early form of the technology for years. With increased access in terms of bandwidth and the economy of scale, the new term (cloud computing) has been adopted, and the technology is attainable and economically viable for small- to medium-sized institutions. The technology is available for a wide range of services and provides several significant benefits, although there are also risks to be aware of.

Financial institutions have been working with private cloud computing solutions with service bureau technologies for decades, but it has been referred to as another name, such as third-party hosting. Knowing this should relieve some of the pressure and concern that many institutions have regarding security risks and whether cloud computing solutions are right for them.

Cloud computing has become more popular now because it is realistically attainable by the masses and there is behind-the-scenes technology that has been put in place to improve reliability, scalability and security. Mobility is also driving a lot of the shift toward cloud solutions, as employees want to be connected more of the time. Building in a higher level of access is significantly easier to do on a cloud solution than it is for an on-premise solution. Back office applications and the data center are now able to be hosted in the cloud and with pipes to the cloud from your institution. However, from a banking perspective, you may need to look beyond a traditional cloud approach.

The due diligence in selecting a cloud provider is of paramount importance, as you want to make sure that a cloud solution can adhere to regulatory demands or is customizable to do so. Some of the larger cloud providers do not always support federal, state or industry regulations in order to appeal to larger audiences, while smaller cloud providers often offer more flexibility but could also not have the long-term viability or internal processes as the more established providers. A one-size-fits-all solution is often not the best for the demands of a financial institution.

For a financial institution, if you are looking at cloud providers for applications or other automation processes, the vendor management – do you do this, can you do this, do you meet these requirements – is a critical factor. It is beneficial to work with someone who understands the technology as well as the requirements that your institution faces and how to successfully bridge that gap. You want to ensure that by going with a cloud computing solution, you are not exposing yourself to non-compliance with certain requirements or leaving yourself vulnerable to security risks or breaches, especially when it comes to customer information.

Just as you have to practice due diligence to ensure that your vendor of choice is helping you meet compliance demands, on the flip side, you can leverage cloud computing to help you meet compliance requirements in areas such as multi-factor authentication, rather than implementing your own solution on-premise. Potentially working with a cloud provider that can hook into your multiple applications, such as remote access or internet banking to provide compliance without having to invest tens of thousands of additional dollars for an on-premise solution is an attractive feature. A similar situation exists for email encryption and email archival. It may be cost prohibitive for a community bank to do that itself, but with maybe only 100 mailboxes, it is relatively cost-effective and simple to employ a cloud initiative.

An increase in bandwidth has made the evolution of cloud computing possible. However, the bandwidth has become a single point of failure as well. A review of your connectivity needs to be a part of your due diligence as you evaluate cloud applications. If you are planning on moving critical core functions to the cloud such as your lending application or email, you may not want to be reliant on a single pipe to get you there. You may want to have a backup of some sort, unless you determine that having a single pipe is a risk that you are willing to take.

Some of the major concerns around cloud computing are as follows:

- **Stability of the vendor:** Where are they going to be in one, three or five years?
- **Data ownership:** What does the fine print say about data ownership once it resides in their data center?
- **Change of plans:** How will they assist you should you decide to change providers, or move back to an on-premise solution?

Interoperability with other key applications is another key concern for institutions. For instance, if you are going to move your mail to a cloud-based solution and next year you want to deploy a voice over IP solution or a CRM solution, would you be able to integrate the two together and what kind of hoops might you have to jump through with your vendor?

Benefits associated with cloud-based solutions include ease of deployment, ease of upgradability and manageability of the systems. At the end of the day, your business is serving the customers of your institution, not providing and implementing IT systems. Cloud solutions are much easier mechanisms to manage as someone else is responsible for the hardware and software; your job is just to get the data in and out of it.

©2011 RSM McGladrey, Inc. All Rights Reserved. Used with Permission.

Accounting Changes on the Horizon for Financial Institutions

By: Tim Tiefenthaler

There are unprecedented and significant changes to the authoritative accounting literature on the horizon. Many of these changes arise from the Financial Accounting Standards Board's (FASB) and International Accounting Standards Board's (IASB) efforts to converge their accounting standards. There are six joint projects by the FASB and IASB that are expected to significantly affect virtually all companies. The six projects are:

- Leases
- Financial instruments
- Revenue recognition
- Consolidation
- Financial statement presentation
- Financial instruments with characteristics of equity

For a high-level summary of each of these projects, McGladrey & Pullen has prepared a document, The Future of Financial Accounting Standards At-A-Glance, which can be downloaded at www.mcgladrey.com.

In this issue of Bank Notes, we highlight the Leases project. The other projects will be highlighted in future Bank Notes issues.

Leases project

In summary, the proposed model would require lessees to recognize an asset for the right to use the leased asset, and a liability for the obligation to make the rental payments. Accordingly, off-balance-sheet accounting (i.e. operating leases) would no longer be appropriate. The most significant implication for lessees will be the gross up of the balance sheet as a result of this proposed standard. Other implications to depository institutions include:

- The increase in total assets for lease assets from others will decrease the leverage capital ratios.
- The increase in total assets will reduce the return on asset ratios.
- Institutions will need to reevaluate buy vs. lease analysis on a prospective basis.
- Loan covenants with customers may need to be modified.
- Potential significant financial implications will occur for customers in the leasing business.
- Potential significant financial implications will result for institutions with leasing divisions.

As of the publication date of this article, the FASB recently decided to expose the proposed leases accounting standard for a second time because of the significance of the changes made to the original exposure draft. While no announcement has been made regarding dates, it is expected that the revised exposure draft will be issued later in 2011, and the final standard is not likely to be issued until 2012.

For a more in-depth review of the Leases project and of each of the highlighted projects, McGladrey & Pullen has prepared an additional publication, More Accounting Changes Coming, which can also be downloaded at www.mcgladrey.com.

Converting Non-Earning Assets, continued from page 1

in the institution granting a concession to the borrower. This definition results in every loan modification potentially constituting a TDR. The accounting rules provide various indicators but don't provide any bright lines for evaluating whether a borrower is experiencing financial difficulty or whether a concession has been granted, resulting in a relatively subjective analysis.

Determining whether a TDR has occurred is essentially a two-step process. Institutions should first evaluate whether the borrower is experiencing financial difficulty. If the borrower is not having financial difficulty, then by definition a modification is not a TDR. If the borrower is experiencing financial difficulty, then the institution must determine whether the modification has resulted in a concession being granted to the borrower. A concession could result from a variety of factors, including changes in a loan's payment terms, interest rate or collateral.

The loan's interest rate is a key factor to consider when evaluating whether a concession has been granted. If the interest rate has been modified to a below-market rate then a TDR has clearly occurred. However, a TDR may also have occurred, even if a loan is being renewed and the interest rate remains the same. Institutions must evaluate whether the new interest rate would be offered to a new borrower with similar credit quality at the time of the modification or renewal. Institutions must also consider whether other market participants would offer those terms to the borrower. If the institution concludes that a new borrower would not have been offered the same terms, then modifying or renewing a loan to an existing troubled borrower and keeping the interest rate the same results in a TDR.

In addition to the interest rate, there are many other considerations when determining if a TDR has occurred. New accounting guidance related to TDRs was issued in April 2011 in FASB Accounting Standards Update No. 2011-02, Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring. While this guidance did not change any of the rules, it did provide clarification. Institutions should refer to this guidance when evaluating their loan modifications as TDRs. Due to the complexity and subjectivity of the TDR rules, it is very important that institutions fully document the analysis and considerations going into their TDR conclusions.

While some REO and TDR transactions are straightforward, many have complex accounting and tax implications. For more information or assistance with these topics, please contact your local financial institution specialist.

©2011 RSM McGladrey, Inc. All Rights Reserved. Used with Permission.

Bank Notes

July/August 2011

Converting Non-Earning Assets into Earning Assets

Cloud Computing for Financial Institutions

Accounting Changes on the Horizon for Financial Institutions

HARDING, SHYMANSKI & COMPANY, P.S.C.
Certified Public Accountants and Consultants

21 Southeast Third Street, Suite 500
Evansville, IN 47708

Address Service Requested

Information provided in this publication has been obtained by Harding, Shymanski & Company, P.S.C. from sources believed to be reliable. However, Harding, Shymanski & Company, P.S.C. guarantees neither the accuracy nor completeness of any information and is not responsible for any errors or omissions or for results obtained by others as a result of reliance upon such information. This publication does not, and is not intended to, provide legal, tax or accounting advice.

McGladrey Alliance is a premier affiliation of independent accounting and consulting firms. McGladrey Alliance member firms maintain their name, autonomy and independence and are responsible for their own client fee arrangements, delivery of services and maintenance of client relationships. McGladrey Alliance is a business of RSM McGladrey, Inc., a leading professional services firm providing tax and consulting services. McGladrey is the brand under which RSM McGladrey, Inc. and McGladrey & Pullen, LLP serve clients' business needs. McGladrey, the McGladrey logo and the McGladrey Alliance signatures are used under license by RSM McGladrey, Inc. and McGladrey & Pullen, LLP.

For additional copies or change of address, contact Harding, Shymanski & Company, P.S.C.
For more information, contact Christy Sayle, CFSA, CICA, at (800) 880-7800, email csayle@hsccpa.com, or Priscilla Capes, CPA, CFE, AAP, at (502) 584-4142, email pcapes@hsccpa.com. Visit our Web site at www.hsccpa.com

Bank Notes

July/August 2011

Printed in the USA

©2011 RSM McGladrey, Inc. All Rights Reserved. Used with Permission.