Bank Notes

A timely information and idea statement

September/October 2010

FASB Issues Disclosure Guidance on Finance Receivables and the Allowance for Credit Losses

On July 21, 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. The new guidance amends Accounting Standards Codification (ASC) Topic 310, Receivables, by requiring more robust and disaggregated disclosure aimed at improving transparency by providing additional information to assist financial statement users in assessing an entity's credit risk exposures and evaluating the adequacy of its allowance for credit losses.

It should be noted that the scope of ASU 2010-20 is not specific to financial institutions, but is rather far reaching due to the FASB's broad definition of a financing receivable. A financing receivable is defined as a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset on the entity's balance sheet. Fortunately, certain receivables were scoped out of ASU 2010-20 such as trade accounts receivable with contractual maturities of less than one year, debt securities, and receivables measured at fair value or the lower of cost or fair value. However, other receivables such as notes receivable, purchased receivables, including those within the scope of ASC 310-30 that are common to financial institutions completing business combinations or loan pool acquisitions, and certain lease receivables are all within the scope of the requirements.

The standard will have a significant impact on financial institutions and will provide unique challenges for financial statement preparers. Most of the disclosures will be required at disaggregated levels known as portfolio segments and classes of financing receivables. A portfolio segment is defined as the level at which a creditor develops and documents a systematic methodology to determine its allowance for credit losses. Examples might include financing receivable type, industry sector of the borrower and risk ratings. Classes of financing receivables are defined as a level of information that enables a reader to understand the nature and extent of exposure to credit risk arising from financing receivables. Classes are generally a further disaggregation of a portfolio segment.

There will clearly be some level of judgment involved in determining portfolio segments and classes and variation will exist among entities. No matter how financial institutions determine their portfolio segments and classes of financing receivables though, the bottom line is there will be a tremendous increase in the volume of required disclosures.

In terms of tabular disclosures, some highlights include nonaccrual loans, past due loans broken down by age (e.g. 30-59 days, 60-89 days, greater than 90 days), impaired loan balances and the related allowance, average carrying value and interest income recognized, allowance activity for the period, and significant purchases of receivables during the period – all now required at the portfolio segment or class level versus an aggregated presentation. Note that the disclosures listed above are just some of the more robust disclosure requirements. We advise readers of this article to review the ASU 2010-20 for a complete listing of new disclosures. McGladrey & Pullen has also recently published a guide providing a thorough analysis of the new disclosure requirements, titled New Expanded Disclosures About Credit Quality of Financing Receivables and Allowance for Credit Losses Required as Early as 2010.

The push for disaggregation is not only for quantitative tabular information but will also be qualitative in nature. For example, significant accounting policies related to loans such as an institution's policy for placing loans on nonaccrual status, receipt of payments while on nonaccrual status and resuming accrual status will now be required by class of financing receivable. Similarly, a company's policy for estimating the allowance for credit losses, including a description of factors impacting the estimate and a discussion of risk characteristics for each segment must now be disclosed at the portfolio segment level. Should a company's allowance policies and/or methodology change during the reporting period, a description of the change and its impact on the financial statements as well as management's rationale for the change will be required.

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Concerns and Opportunities for Community Banks Resulting from the Dodd-Frank Act

The Dodd-Frank Act was signed by President Obama on July 21, signaling a significant amount of change to all financial institutions. The act aims to bring a higher level of regulation to institutions in order to protect consumers and strengthen the financial system as a whole to avoid a repeat of the difficulty in the industry over the last two years. The act will have a direct effect on how many community banks conduct business, as well as some indirect effects and unintended consequences.

McGladrey & Pullen Partners Dan Trigg and Tim Moritz were recently part of a webinar to discuss the Dodd-Frank Act as well as other current industry issues. The webinar summarizes many facets of the act, taking a look at accounting, regulatory compliance, corporate governance and capital planning and raising concerns.

Recent Guidance May Require Review of Incentive Compensation Policies

Several years before the recent banking meltdown and broader economic recession, U.S. markets began to use the word "crisis" to describe the current state of corporate governance in America. The initial focus of capital markets and the media was on stronger accounting rules, more disclosure and corporate governance. As legislative initiatives emerged, the spotlight turned to executive compensation and issues pertaining to disclosure and the misalignment of performance, risk and pay. The ongoing financial malaise has served to accelerate the development of regulatory requirements developed to address this real or perceived misalignment.

The Interagency Final Guidance on Sound Incentive Compensation Policies was released on June 21, 2010 by the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation. The guidance is intended to assist banks in the design, implementation, measurement and oversight of incentive compensation programs so they may effectively consider potential risks and risk outcomes. The guidance is principles-based; that is, it does not provide hard and fast rules or limits that must be applied to incentive compensation arrangements. Rather, and with "crisis in corporate governance" as a starting point, the guidance establishes three core principles for incentive compensation:

1. Provide employees with incentives that appropriately balance risk and reward
2. Develop these incentive compensation arrangements so that they are compatible with effective controls and risk-management
3. Ensure that incentive programs are supported by strong corporate governance, including active oversight by the organization's board of directors

The guidance does not apply to banking organizations that do not use incentive compensation, but does apply to all banking organizations using incentive compensation that are U.S. banks, U.S. commercial lending operations and the U.S. operations of foreign banking organizations. The guidance distinguishes between large banking organizations (LBOs), smaller banking organizations and banking organizations that are significant users of incentive compensation. While LBOs "should have and adhere to systematic and formalized policies, procedures and processes,…the policies, procedures and systems of smaller banking organizations that use incentive compensation arrangements are expected to be less extensive, formalized and detailed than those of LBOs".

While the guidance does not provide hard criteria for determining whether a bank is a significant user of incentive compensation, a smaller banking organization would not be considered a significant user of incentive compensation arrangements if these arrangements consisted of only a firm-wide bonus program based on profitability. Further, the agencies' expectation is that many smaller, non-complex banking organizations that do not make significant use of incentive programs may be able to satisfy the guidance through existing internal control, audit and governance approaches.

For those banking institutions that are significant users of incentive compensation, regulatory examiners will utilize the guidance as a basis for the review of a banking organization's incentive compensation practices. The results of these examinations will influence CAMEL ratings and, as a result, its deposit insurance assessment rates, eligibility for expedited applications processing and approval, and exposure to enforcement actions.

The guidance focuses on three groups of employees: 1) senior executives; 2) individuals, who by their authority to commit bank assets can have a material impact on a banking organization (e.g., traders); and 3) those groups of employees who collectively can have a material impact on a banking

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organization (e.g., lenders). We believe that banks can follow a "risk-focused" approach:

- Utilize the bank's income statement to identify the most significant lines of business
- Identify the material risk-takers in each business area
- Evaluate the incentive compensation arrangements for these individuals
- Determine if these individuals are being incented to take risks
- Decide if the three core principals are supported by the current incentive arrangements
- Modify these arrangements based upon the findings (plan design, controls and risk management, board oversight)

Since most banks have employees in at least two of the three groups described above, and to the extent that any of these employees participate in an incentive compensation program, the bank should review any and all incentive plans for which the employees are eligible. If risk issues are identified within any of these plans, and as plans are often modified on a year-to-year basis, all incentive plans should be part of the bank's annual risk and compensation committee review process in preparation for ongoing agency examinations. Board-level compensation committees may now have direct oversight and approval of incentive programs for non-executive employees.

The Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law on July 21, 2010, one month after the release of the Interagency Final Guidance, likely provides another layer of regulatory requirements for many financial institutions. While wide-ranging in scope, a small portion of the act, like the guidance, seeks to prohibit "certain compensation arrangements" among "covered financial institutions" (most banking institutions with assets of $1 billion or more). By April 21, 2011, the appropriate federal regulators will jointly prescribe regulations or guidelines requiring each covered financial institution to disclose to the appropriate federal regulator the structure of all incentive-based compensation arrangements. Additionally, the agencies will prepare a report after the conclusion of 2010 on the trends and developments in compensation practices at banking organizations to ostensibly provide additional guidance.

We believe that, in anticipation of this additional guidance and these regulations, "covered institutions" are best served by reviewing and (where appropriate) modifying their incentive arrangements so that when disclosure is required and when examinations take place, incentive arrangements would already reflect Federal Reserve Governor Daniel K. Trullo's statement that, "The Federal Reserve expects firms to make material progress this year on the matters identified as we work toward the ultimate goal of ensuring that incentive compensation programs are risk appropriate and are supported by strong corporate governance."

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The challenge most companies will face for some of these new or modified disclosures is the lack of a current process in place to track the information necessary for disclosure. For example, the ASU introduces the concept of credit quality indicator disclosures, which include statistics about a finance receivable's credit quality such as consumer credit risk scores or risk ratings, loan-to-value ratios, collateral information, etc. While this information is generally analyzed by financial institutions in some form, the information is not sufficiently tracked by many community banks in a manner that will allow financial statement preparers to manipulate the data for disclosure, particularly at the financing receivable class level as it is required. Another example will be the new disclosure requirements for troubled debt restructurings (TDR). The nature and financial statement impact of modifications resulting in TDR treatment as well as re-default rates on those TDRs must now be tracked and disclosed. Management must also provide disclosures regarding how the re-default rate was factored into the determination of the allowance for credit losses.

For public companies, the requirements for ASU 2010-20 are effective for interim and annual periods ending after Dec. 15, 2010 and will only relate to balance sheet disclosures. Disclosures regarding activity during the period (e.g. allowance activity, purchases and sales, etc.) will not be effective for public companies until interim and annual periods beginning after Dec. 15, 2010. The requirements for nonpublic companies are effective for interim and annual periods ending after Dec. 15, 2011, but will include all of the required disclosures rather than a phased in approach. Although encouraged upon adoption, comparative disclosures are not required until reporting periods ending after the initial adoption date.

Because of some of the challenges alluded to earlier, public companies will not want to delay in assessing the impact this ASU will have on the financial reporting process. There will likely be a fair amount of work required during the upcoming fourth quarter for most public institutions to ensure compliance with the disclosure requirements.

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Printed in the USA

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