

Bank Notes

A timely information and idea statement

September/October 2011

Maximize performance with key risk indicators

By: John P. Behringer

In the current economic environment, it is critical that financial institutions—particularly community banks—be aware of emerging risks facing their company. An efficient and effective way to do this is to identify and develop key risk indicators. Unlike performance indicators that focus on measuring historical activity, risk indicators focus on emerging risks that threaten the company's continued performance or recovery. Establishing this framework enables a financial institution to recover, improve or maintain its performance, as well as improve its response to emerging trends and enhance its policies governing operational and regulatory areas.

The "Great Recession" and its aftermath have had an unusually harmful impact on the community banking industry. This impact is evidenced by the number of commercial bank failures resolved by the Federal Deposit Insurance Corporation (FDIC) since 2008. Among the primary causes of stress on the industry are increased exposure to commercial real estate, widening enforcement actions by examiners and less-stringent risk management activities, both prior and subsequent to the crisis. This relaxation of risk monitoring has occurred at some financial institutions despite increases in overall risk profile.

Regulatory impact of the Great Recession

In response to the industry stress and bank closure activity, regulators are using lessons learned during the recession to shape their supervisory activities going forward. One consequence of this is more rigorous examinations of many financial institutions. The tightening of exam standards can also be attributed in part to findings published in a December 2010 report by the FDIC inspector general. The report summarized the findings of Material Loss Reports issued for banks that had failed since 2008. The inspector general's report concluded that tightened regulatory and supervisory action was warranted in order to mitigate the risk of bank losses and failures, whether caused by high-risk profiles, weak risk management practices, or both.

Additionally, regulators have been issuing both informal and formal enforcement actions at a brisk pace since 2008. These enforcement actions (and corresponding downgrades in the composite CAMELS ratings of institutions) have contributed directly to the uneven recovery of community banks, and indirectly to the uneven recovery of the U.S. economy as a

whole. In the case of distressed institutions, enforcement actions typically have a direct impact on lending limits, resulting in increased capital requirements and reduced access to wholesale funding sources, which themselves will reduce lending activities. The end result is a weaker institution that may be unable to generate earnings sufficient to fund the costs necessary to resolve its problem loan portfolio, eventually resulting in failure of the institution.

In the case of performing institutions, concerns about regulatory scrutiny of loan activity coupled with the need to conserve capital in an uncertain economic and regulatory climate, also have detrimental effects on their overall condition. The first result is a tightening of credit availability, which has a negative impact on the economic recovery of the communities they serve. A second consequence is less-than-optimal earnings for the institution.

Comparing risk and performance indicators

In order to effectively manage a financial institution in the current environment, its management must identify and develop forward-looking key risk indicators (KRIs) that monitor emerging fundamental business, regulatory and reputational risks. For performing institutions, KRIs will enhance the enterprise risk management (ERM) framework, as well as assist them in maintaining current performance levels, while concurrently mitigating the risks associated with regulatory enforcement actions and corresponding reputational issues. For institutions under a formal or informal enforcement action, KRIs will help monitor threats to the recovery process, as well as identify opportunities for improvement.

As mentioned above, KRIs and KPIs have different objectives and focus on different issues. While KPIs typically focus on measuring historical activity, KRIs focus on emerging risks to the institution. For example, a KPI measuring asset quality would compare non-performing loans to total loans. While this ratio is critical to assessing the current health of the loan portfolio, it offers no insight or information regarding emerging risks within the loan portfolio. Furthermore, since non-performing loans have already migrated to non-accrual status, KPIs will not help management to identify proactive measures that can be taken to mitigate losses within the portfolio. In contrast, KRIs focus on identifying and

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Guidelines for tax record retention

By: Patti Burquest and Bob Adams

The cornerstone of successful management of an IRS examination for financial institutions is a sound records retention policy. The failure to maintain records for the proper amount of time and in the right format can lead to increased tax liability, penalties and interest. Generally, any business record that supports or proves an issue on the institution's tax return should be kept. This requirement is stated in section 6001 of the Internal Revenue Code, which also stipulates that records must be available at all times for inspection by the IRS. Although section 6001 may sound simple and straight-forward, it can be complex to implement in the real world. The burden of proof is placed on the taxpayer to determine the length of time to keep the record, in what format, whether facsimiles are acceptable as proof, whether backup files are necessary, and a host of other issues relating to management of records. The issue becomes even more complex with a corporate merger, where conflicting record systems and obsolete technologies raise new questions on how to interpret the law.

In terms of what to keep and for how long, section 6001 requires that the records must be maintained so long as they may be material in the administration of the tax law. The general rule is to keep any record that supports an item of income or deduction until the statute of limitations expires (generally three years from the date the return is filed). Typically, the IRS can audit a return and assess additional tax only during the statutory period. Thus, such information as sales, cost of goods sold and inventory would need to be kept only as long as the statute of limitations for that particular return has not expired. However, there are exceptions to this rule. Institutions must keep records of their basis in assets (e.g., buildings, land, fixtures) almost indefinitely to substantiate capital gain or loss on the asset's final disposition. Net operating losses and other carryback items can often extend the time frame that records are kept for the carryback years. Employee wage and salary information provided to the Social Security Administration, other federal agencies and to state tax administrations must also be kept for many years.

Another key issue is the format or storage medium of the record, and whether it will meet the requirements of section 6001. Whether the records are electronic records, databases, microfilms, scanned images, hardcopy or are kept on external storage media, a number of questions can arise as to how these records should be maintained to support information on the tax return. The IRS has issued detailed guidance on this issue in the form of Revenue Procedures, three of which are discussed in this article.

External storage media and scanned images

Revenue Procedure 97-22, 1997-1 C.B. 652, establishes guidelines for taxpayers whose hard copy original records are scanned into an electronic storage system, or whose electronic records are transferred to an external storage medium, such as laser or optical disks. In order to meet the requirement, the scanned or transferred image must reliably transfer, store, preserve and reproduce the original record, and must have "a high degree of legibility when reproduced". Legibility and

readability is required for both paper reproductions and for records displayed on a video display terminal.

Additionally, the electronic storage system must have an indexing system that allows retrieval of the records and the ability to reproduce the record in hard copy form upon the request of the IRS. If the financial institution maintains a separate set of records or source documents, whether in hardcopy or in an automated data processing system, the two information systems must be cross-referenced in a way that creates an audit trail between the two. A procedural manual which explains the use of the electronic storage system must be made available to the IRS during an audit, as well as any other resource needed to access the documents (e.g., software, trained personnel). Moreover, the IRS is authorized to test equipment for compliance with section 6001. If a deficiency is found in the electronic storage system and no backup documents exist, the officer may issue a *Notice of Inadequate Records*. Such a notice would present difficulties for companies that issue audited financial statements in reliance on the integrity of financial records. Furthermore, the failure to maintain adequate records could support the imposition of the accuracy related penalty under section 6662 of the Code, and, in certain circumstances, criminal penalties.

These rules raise a number of questions for financial institutions. For example, can the records be kept in data compression formats? Generally yes, according to Rev. Proc. 97-22, which accepts this practice as long as the compressed information can be retrieved and reproduced during an audit. Another question is whether to keep the originals or hardcopies of books and ledgers, as well as the original source documents, where a microfilm copy exists. Generally, these backup documents do not need to be kept, as long as the electronic storage system is in compliance with the key requirements (legibility, readability, accessibility, etc.) of section 6001.

Another problem occurs where records reside on an obsolete technology or one that is no longer actively maintained. This is a common dilemma facing financial institutions after an acquisition, where the institution decides to retire or deactivate the acquired company's systems or software. Once again, the key consideration is to ensure that such records are available and reproducible in the event of an IRS exam. To meet this requirement, the institution should take steps to convert or transfer the information, maintain the older technology, or initiate whatever solution is deemed cost-effective and appropriate for their situation. If this is not done and the records reside on systems or software that are no longer supported by the institution and hence, are not accessible to auditors, then from the IRS' viewpoint, the records will be "deemed destroyed by the taxpayer", a determination that could lead to the issuance of a *Notice of Inadequate Records* and potential penalties associated with the inability to substantiate items on the tax return.

To read more, go to: <http://mcgladrey.com/Bank-Notes/Guidelines-for-tax-record-retention>

Impairment model will change how loan loss allowances are estimated

By: John Sproull

Whether you are a small community bank with a limited appetite for risk or a large financial institution with complex investment strategies, the Accounting for Financial Instruments Joint Project, commonly known as the Financial Instruments Project, will affect your organization. The goals of the project are to improve the usefulness of financial instruments reporting, simplify accounting standards and increase convergence with international financial reporting standards. Among the issues it addresses are recognition and measurement of financial instruments, impairment of financial assets and hedge accounting.

One of the elements under development is a new credit impairment model, which will significantly change the way companies estimate the allowance for loan losses. To explain how the current model is being developed, let's review how we arrived at this position. On January 31st of this year, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) issued a supplementary document for the purpose of soliciting comments on a proposed credit impairment model for open portfolios of financial assets. The supplementary document was the product of previous exposure drafts issued by the Boards and comment letters received from various parties. The comment period closed on April 1, 2011, with 212 responses from banks, insurance companies, trade groups, regulatory agencies, audit firms and other interested parties.

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measuring emerging risks that threaten the financial performance, regulatory status and overall success of the financial institution.

Use COSO and CAMELS guidance to develop KRIs

Based on guidance provided by COSO (Committee of Sponsoring Organizations of the Treadway Commission), the key to developing and implementing an effective set of KRIs is to identify metrics that offer insight into emerging risks threatening the institution's continued performance (or recovery, as it were). Furthermore, COSO advises that recognizing critical linkage between fundamental risks and core strategies will assist the institution in isolating relevant metrics that can serve as leading indicators of emerging risks.

Based on this guidance, institutions should consider developing a set of KRIs around the CAMELS rating system used by regulators. This approach allows an institution to address both operational and regulatory risk exposure under the umbrella of managing its overall reputational risk. It is a scalable process for developing and implementing KRIs within an institution's existing ERM or risk assessment process, regardless of asset size, risk management resources or complexity of overall operations.

The high response level showed the significant interest and attention being paid to the proposed credit impairment model.

The Good Book and Bad Book Approach

By effectively establishing a methodology that results in earlier loss recognition as compared to the current incurred-loss model, the proposed impairment model would change the way financial institutions evaluate their allowance for loan losses. The model proposed that financial assets be split into two groups, a "good book" and a "bad book," with an allowance computed for both books separately. The division of the good book and bad book portfolios was based on an evaluation of the degree of uncertainty about collectability. The bad book required the entire amount of expected credit losses over the remaining life of the portfolio to be recognized immediately. The good book required the higher of (1) the time proportional expected credit losses or, (2) the credit losses expected to occur within the foreseeable future. The time proportional expected credit losses represented a portion of expected lifetime losses based on the age of the financial assets relative to their expected life.

To read more, go to: <http://mcgladrey.com/Bank-Notes/Impairment-model-will-change-how-loan-loss-allowances-are-estimated>

Additionally, emerging regulatory trends indicate continued emphasis on timely and relevant stress tests, not only for commercial real estate but for all segments of the loan portfolio. Effective KRIs can assist management in identifying and developing stress scenarios and trigger events that could have an impact on stress tests pertaining to asset quality, capital and liquidity. The resulting asset quality stress test data could then be utilized to develop and execute capital and liquidity stress tests.

By identifying an effective set of leading KRIs, management can enhance its stress testing process. During this process, management should evaluate the integrity of the data utilized in the KRIs and to complete stress tests. As with any process that relies significantly on information systems, the integrity of the data inputs will determine the reliability and validity of the resultant outputs. Since this data is essentially driving key strategic decisions within the organization, management should take steps to ensure the quality and integrity of the data. The strengths and weaknesses of reporting systems should be critically assessed to determine if upgrades or enhancements are needed.

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