



Current Regulatory Hot Buttons

By: Dan St. Clair, CPA
Audit Principal

Each year CPAs, accountants, CFOs and auditors try to identify what the current issues are that the regulatory agencies will be looking for. Over the past few years the focus has been on asset quality and revenue recognition, and that trend should continue into 2012. Items scrutinized over the past few years include gains related to the sale of Small Business Administration (SBA) loans, recognition of origination fee income and reporting of deferred tax assets.

We were recently at a state industry convention and the Regulatory Panel discussed several issues related to the reporting and classification of loans. The foremost topic discussed was related to asset quality and internal grading of loans. Over the past few years there have been an increased number of credits that do not have adequate documentation to support the repayment of the loan balance. Stale financial statements and tax returns are more and more common in loan files. Having outdated financial statements does not support the current state of the borrower and can lead to the downgrade of a specific credit based on the lack of documentation alone. The grading of the loan should be based on the borrower's ability to repay and should not be solely supported by the underlying collateral.

Another topic of discussion related to the adequacy of appraisals. How current is the information? Was it properly done with reasonable assumptions and comparatives? Did the bank perform a desktop review? If there are questions related to the repayment of a loan where the credit is collateral dependent, or if the credit is being moved into Other Real Estate Owned, an updated appraisal performed by an independent consultant is most likely to be expected.

The proper reporting of Troubled Debt Restructuring (TDR) was discussed at length. It was noted by the regulators that many community banks still show zero amounts on their Call Reports related to TDRs. Due to the current economic environment, it seems unusual to have so few

of items where concessions have been made for borrowers experiencing financial difficulties. This appears to be an area for increased questioning and is easily based on the reporting within the Call Reports.

There appears to be common themes in all of these and other regulatory discussions, mostly to increase the internal and supporting documentation related to decisions. Expectations related to regulatory capital percentages and allowance for loan and lease loss percentages continue to rise. There is a move towards more regulatory enforcement actions, which are becoming more common and are often accompanied by requirements to increase regulatory capital and loan loss coverage. There also appears to be more scrutiny on how the bank compares with its peer group. Outlying institutions that skew the peer group averages are being looked at very closely.

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So what can you do? Start preparing for your next exam now. Make sure your documentation is current and complete. Be honest with yourself about your borrower's current situation. Lenders often give the borrower the “benefit of the doubt” that examiners are unwilling and unable to provide. Be conservative. If there are several situations that are border-line, don't always round up. Make Enterprise Risk Management a primary focus. Take a portfolio view of the enterprise. Don't just focus on the individual pieces. Take a step back and look at the big picture as well.

Troubled Debt Restructuring Rules

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The Financial Accounting Standards Board (FASB) has issued Accounting Standards Update (ASU) No. 2011-02 to improve financial reporting related to Troubled Debt Restructuring (TDR). The FASB explained that additional guidance and clarification was needed to help creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties for purposes of identifying whether a specific restructuring constitutes a troubled debt restructuring. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that both a) the restructuring constitutes a concession and b) the debtor is experiencing financial difficulties.

The creditor should carefully consider, and adequately document, their evaluation of whether it has granted a concession. If a debtor does not otherwise have access to funds at a market rate with similar characteristics, the debt would likely be considered to be at a below-market rate, which may indicate that the creditor has granted a concession. Other circumstances that could indicate a concession are unusually favorable terms or delays in repayments that are not deemed insignificant.

For the evaluation of whether the debtor is experiencing financial difficulties, the creditor should evaluate whether it is probable that the debtor would be in payment default on any of its debt in the foreseeable future without the modification.

FASB Codification 310-40-15-5 states: A restructuring of a debt constitutes a troubled debt restructuring for purposes of this Subtopic if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.

The key appears to be clear documentation of the thought process behind the modifications being made, including the comparability of the terms and rates being used and the economic status of the debtor.

Has a concession been made? A modification to reduce the interest rates or increase the repayment period would not be a TDR if the goal is to retain a borrower and keep them from moving to another lender or to match other, more favorable terms available to the borrower on the open market.

Is the borrower experiencing financial difficulties? In cases where payment default is probable, it would generally be appropriate to conclude that a debtor is experiencing financial difficulties. In cases where the modification is to reduce expenses or increase cash flows but the repayment of credit is not at risk, this conclusion should be clearly documented.

The documentation and related support should be clearly laid out to guide the examiner and lead the reviewer to the same conclusions.

IRS Examinations

*By: Marilyn Fowler, CPA
Senior Tax Manager*

Over the past year the Internal Revenue Service has increased the number of examinations performed on banking entities. One of the best lines of defense is to have a Conformity Election, or at the minimum, an Express Determination Letter from the federal regulators.

The Conformity Election allows for certain items to be calculated the same for both book and tax purposes, thus saving valuable resources of the bank for tax return preparation and possible tax return examinations. Some of these items include: nonaccrual interest on loans, appraisal of Other Real Estate Owned (OREO) and charge-offs to bad debt expense.

In order to make this election with the IRS, an Express Determination Letter is needed from the federal regulators for the last federal examination before the first day of the year for which the election is made. For example, to have the election effective for the tax year beginning January 1, 2012 you would need the EDL by December 31, 2011. An EDL would need to be requested at each subsequent exam.

These are some of the key issues that the IRS are targeting when examining banks: large book/tax differences that reduce taxable income, fair market value of OREO foreclosures when determining the bad debt write-off and holding costs associated with OREO property.

Please feel free to contact **Marilyn Fowler** at **713-667-9147** if you would like to discuss these topics more in depth.

Credit Disclosures

*By: Travis Williams, CPA
Audit Manager*

As a reminder we wanted to mention Accounting Standards Update (ASU) No. 2010-20 – “Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses” again. This was issued in July 2010 and is effective for non-public companies with reporting periods ending on or after December 15, 2011.

This ASU provides new terminology for financing receivables (which includes loans) and requires more information to be disclosed relating to receivables and the allowance for financing receivables; however, it will not have a significant change in practice. Certain disclosures will now be required to be broken out into one of two areas: portfolio segment and classes of financing receivables.

- A portfolio segment is defined as the level at which a financial institution develops and document a systematic method for determining its allowance for credit losses.
- Classes of financing receivables generally are a disaggregation of a portfolio segment.

This ASU affects current disclosures and creates new disclosures as shown below. The changes to the current disclosure are as follows:

- The allowance roll forward will be presented by portfolio segment.
- The recorded investment in the receivable and the ending balance of the allowance for each portfolio segment will be disclosed in the allowance roll forward. This will be disaggregated on the basis of the impairment method (for example, individually evaluated for impairment, collectively evaluated for impairment and loans acquired with deteriorated credit quality).
- The non-accrual status of receivables will be presented by class.
- The impaired receivables will be presented by class.
- All receivables past due 90 days or more and still accruing interest will be present by class.

The following are new disclosures for the current year:

- The credit quality of the loan portfolio will be presented by class by credit quality indicators. Examples of credit quality indicators include: consumer credit risk scores, credit rating agency ratings, internal credit risk grades, LTV ratios, collateral, collection experience, etc.
- The aging of financing receivables will be presented by class.
- The nature and extent of troubled debt restructurings (TDR’s) that occurred during the period will be presented by class of receivable. This also includes any current modifications of receivables that would classify as a TDR to be disclosed by class.
- Significant purchases and sales during the period will be presented by portfolio segment.

This ASU can be found on the FASB’s website (www.fasb.org) and it provides illustrative disclosures in paragraphs 310-10-55-7 through 310-10-55-11 for the items mentioned above. If you have any questions regarding the new disclosures please contact **Dan St. Clair** or **Travis Williams** at **713.667.9147**.

New address effective: January 23, 2012: