FINANCIAL INSTITUTIONS

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Bidding on Financial Institutions Put in Receivership

OVERVIEW

Bidding on a bank that has been put in receivership is an event that may only happen once for a potential buyer. Being prepared to act in an orderly fashion will help you make the most of this opportunity to expand your market and/or leverage your institution's strengths. This article will touch on some items to be aware of if a bid opportunity becomes available to your institution.

Notification of Bid Package

To be eligible to place a bid, you must be registered with the FDIC through FDICconnect. This will notify you of banks put in receivership that you may have an interest in bidding on. If you have not registered, visit the FDIC website at https://www2.fdicconnect.gov. Upon receiving notification that a bank is going into receivership, it is important to contact the FDIC project manager as soon as possible to gain access to the online FDIC bid information and determine the level of interest in the bank.

Requirements for Bidding

You should contact your primary federal and state supervisory regulators early in the process for approval to bid. It is helpful to have preliminary pro forma financial information to reflect the impact of a FDIC assisted transaction on your organization. Receiving notification that a bank is going in receivership is not an automatic approval to submit the bid. Your primary supervisory regulators must give approval for the bid to be submitted. In general, to be approved, a bank must be well-capitalized and not under any formal enforcement action. Banks under informal enforcement action (MOU or written agreement) may be allowed to bid if all safety and soundness issues are satisfactorily addressed.

Bid Process

The bid process is quick and due diligence is limited. The information for review will be available electronically by the FDIC in advance of going out for on-site due diligence. On-site due diligence is usually limited to only a couple of days per bidder. Due diligence can be accomplished in the timeframe permitted; however, executive decisions (i.e., adequate discounts for loans, etc.) will need to be made in a quick and confident manner.

You may have the option to bid with a loss share arrangement, or a straight purchase and assumption agreement. A loss share arrangement is an agreement with the FDIC that allows for a percentage of the losses incurred on loans and other real estate purchased to be guaranteed by the FDIC. The loss share arrangement is usually 80 percent and helps reduce the exposure of the acquiring institution, but will also require more administrative time for the accounting of the loss share agreement.

Be aware of the following key terms:

- **Intrinsic Loss Estimate** – This is the FDIC's estimated loss on loans and other real estate of the failing bank. This is an amount that must be considered when calculating the bid, but should not be a substitute for your own due diligence, especially in a bid without a loss share arrangement.
- **True Up Provision** – This is a "claw back" provision that allows a portion of the initial discount on the bid to be paid back to the FDIC after the loss share agreement lapses and the actual amount of losses is compared to the original discount bid.

Bidding on Financial Institutions—continued on page 5

Mark Your Calendar

Save the date for our 2010 Bank Seminars:

Thursday, October 28
Mankato, Minnesota

Thursday, November 4
Fargo, North Dakota

Thursday, November 18
Sioux Falls, South Dakota

CPAs & BUSINESS ADVISORS

Tax Legislation Update

OVERVIEW

Congress recently passed a flurry of tax legislation that will have a substantial impact on community banks and their shareholders. On March 18, 2010, the President signed the Hiring Incentives to Restore Employment Act of 2010 (HIRE Act) into law, followed by the massive health care reform legislation, which contained many tax provisions. This legislation will present many challenges to community banks, but will also provide many opportunities that can be fully utilized by taxpayers, if proper tax planning is done in advance.

HIRE Act

The HIRE Act contains various tax provisions that will benefit many businesses, and includes the following highlights:

Enhanced Section 179 expensing extended—For tax years beginning in 2010, the maximum amount a business may expense is $250,000, and the expensing election begins to phase out when a business buys more than $800,000 of expensing-eligible assets. These dollar limits are the same as those which were in effect for 2008 and 2009. Had the HIRE Act not been passed and signed into law, these dollar limits would have dropped this year to $134,000 and $530,000, respectively.

Payroll tax holiday and up-to-$1,000 credit for employers who hire unemployed workers—An employer that hires a worker who has been unemployed for at least 60 days receives an exemption from paying the employer's 6.2 percent share of the Social Security payroll tax on that employee for the remainder of 2010.

In addition to the payroll tax holiday, for any qualifying worker hired under this provision who is kept on the employer's payroll for a continuous 52 weeks, the employer is eligible for an additional non-refundable tax credit of up to $1,000, after the 52-week threshold is reached. The credit is calculated as being the lesser of $1,000 or 6.2 percent of the wages paid by the taxpayer to the retained worker during the 52-consecutive-week period. This credit is to be taken on the employer's 2011 tax return. In order to be eligible for this credit, the employee's pay in the second 26-week period must be at least 80 percent of the pay in the first 26-week period.

Employees hired after the date of introduction of the legislation (February 3, 2010) are eligible for the payroll tax forgiveness and the up-to-$1,000 tax credit, but only wages paid after March 18, 2010, receive the exemption for payroll taxes.

Other highlights of the payroll tax holiday and up-to-$1,000 credit are:

- There is no minimum weekly number of hours that the new employee must work for the employer to be eligible, and there is no limit on the dollar amount of payroll taxes per employer that may be forgiven.
- An employer cannot claim the new tax breaks for hiring family members.
- A worker who replaces another employee who performed the same job for the employer isn't eligible for the benefit, unless the prior employee left the job voluntarily, or for cause.
- For the hiring to qualify, the new hire must sign an affidavit, under penalties of perjury, stating that he or she hasn't been employed for more than 40 hours during the 60-day period ending on the date the employment begins.
- The incentive isn't biased toward either low-wage or high-wage workers. A business will save 6.2 percent of payroll taxes on a $20,000 per year employee or a $75,000 per year employee.

Health Care Reform Legislation

The massive health care reform legislation contained a bevy of tax provisions. The following highlights will likely affect community banks and their shareholders:

Tax credit for small employers providing health insurance coverage—Employers with no more than 25 full-time equivalent employees (FTEs) and whose employees average less than $50,000 of wages per year, are eligible for this credit. Two percent shareholders of an S Corporation employer, and five percent owners of a C Corporation employer are not treated as employees for purposes of this credit.

This credit is available during the 2010 through 2013 tax years. After 2013, the credit is only available to an eligible small employer that purchases health insurance coverage for its employees through a state exchange, and is only available for two years.

The credit is generally 35 percent (50 percent for tax years beginning after 2013) of the employer's nonelective contributions toward the employees' health insurance premiums. The credit phases out as company size and average wages increase. The full amount of the credit is available only to an employer with 10 or fewer FTEs and whose employees have average, annual full-time

equivalent wages from the employer of no more than $25,000.

It should also be noted that when computing FTEs and average wages, they need to be aggregated if employers are under common control. For example, a multi-bank holding company needs to aggregate all of the FTEs and wages for its banks when computing eligibility for this tax credit.

Increase to Medicare Tax Rate—Effective in 2013, an additional 0.9 percent Medicare HI tax is imposed on the employee share, but only to the extent that an individual's wages exceed $200,000 ($250,000 for joint filers). This increase is entirely on the employee share, not the employer share.

Medicare Surtax on Investment Income—Effective in 2013, individual taxpayers with adjusted gross incomes of more than $200,000 ($250,000 for joint filers) will face a 3.8 percent excise tax on their "net investment income," provided that amount falls above the aforementioned thresholds.

"Net investment income" includes interest, dividends, annuities, royalties and rents. It also includes passive income (pass-through earnings from S Corporations or partnerships in which the individual does not materially participate). And it also includes net business income from trading in financial instruments and commodities. Capital gains and other taxable gains from the disposition of property are also included, except for gains on the sale of a nonpassive interest in a business.

Health Insurance Coverage Mandate—Effective in 2014, employers with at least 50 full-time employees are subject to a non-deductible excise tax if they fail to make affordable health insurance coverage available to employees. The excise tax is $2,000 annually per employee. However, the tax excludes the first 30 employees in the computation.

The health care reform legislation contains various other tax provisions that are important to community banks and their shareholders. Please refer to our web site, www.eidebailly.com, for an extended version of this article posted on the Financial Institutions section of the site.
It is imperative that businesses and individuals familiarize themselves with the impact of this legislation on their tax situations and consult with their tax advisors to help measure the impact of these new tax laws. Proper planning and tax strategy implementation can help minimize the cost of new laws, as well as maximize newly available tax benefits. ■

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Meet Our Newest Financial Institutions Partners!

Rhea Hemish, CPA, Mankato Partner
With more than 17 years experience, Rhea consults with banks regarding tax research issues, strategic planning, regulatory reporting and financial projections related to mergers, acquisitions, capital planning and de novo banks.

Keith Osborn, CPA, Norman Partner
Keith provides consulting services to clients, focusing on tax, estate, gift and retirement planning. He also provides accounting services to financial institutions, high net-worth individuals, and oil and gas clients.

Visit our website at www.eidebailly.com/news to view the complete news release.

Buy/Sell Considerations for Financial Institutions

OVERVIEW

Used properly, a buy/sell agreement is a great tool to provide direction for all kinds of triggering events that affect shareholders. Ask yourself, do you have a buy/sell agreement? Do you know what your buy/sell agreement says? How is your buy/sell agreement funded?

The most common multiple found in the financial institution industry is the price-to-book multiple. There has been significant change in these multiples seen in the marketplace since 2008, and any formulas or prices set by this type of multiple may warrant a review.

For many shareholders in financial institutions, this business investment is the most significant financial asset they own. One of the most common ways to realize the value or provide liquidity of that investment is through an effective buy/sell agreement. However, many financial institutions either don't have a buy/sell agreement or have one that simply won't work as the shareholders expected. Some of these agreements are referred to as "ticking time bombs!"

Ask Yourself These Three Questions:

- Do you have a buy/sell agreement?
- Do you know what your buy/sell agreement says?
- How is your buy/sell agreement funded?

We often find agreements are not current, have a price determination that isn't fair or workable for all parties and lack funding for triggering events. Those situations can result in protracted litigation and sometimes the demise of the business.

It may be time to pull that old agreement out of the drawer and read through it again. The most common multiple found in the financial institution industry is the price-to-book multiple. There has been significant change in these multiples seen in the marketplace since 2008, and any formulas or prices set by this type of multiple may warrant a review.

Buy/sell agreements are also critical to business owners considering exit planning. The four most common ways that business owners exit privately held businesses are to sell to a third-party, sell to employees, transition to family members or liquidate. Buy/sell agreements provide guidance in all of these situations. Imagine each exit strategy and read through your buy/sell agreement to see if the language is clear and provides the results you want.

After working with clients through litigation and various disputes, we've realized the importance of understanding how the buy/sell agreements work. A good review of buy/sell agreements focuses on three key areas: triggering events, pricing and funding.

Triggering Events

The agreement should define the process for triggering events, such as shareholder retirement, termination, death, disability, sales, divorce and bankruptcy.

Pricing

Pricing is usually defined by a fixed price, formula price or an appraisal.

Fixed Price

- Fixed prices are easy to understand.
- Fixed prices are easy to set initially, but may be difficult to reset as time passes and interests diverge.
- Provisions are seldom updated and inequities are likely to result.
- Agreements are often out of date when inked.

Formula Price

- Formulas provide a mechanism to update the value based on various metrics in the business.
- Formulas selected at a point in time rarely provide reasonable and realistic valuations over time.
- Changes that occur in companies, industries, local, regional, national and world economies may impact the "true value" of an enterprise relative to any set formula.
- Formulas can be misinterpreted—or are subject to multiple interpretations.

Appraisal

- The valuation process can be known by all parties at the outset.
- All parties know what will happen when a trigger event occurs.
- Parties will always know the current value for the buy/sell agreement (helpful for planning all-around).
- Appraisers can incorporate key business drivers and risks into the value.

Funding

The agreement should spell out how transactions will be funded in situations where the company buys shares back from shareholders or funding

the buyout of other shareholders. Management should know and have a plan for:

- Who buys the shares?
  - Other shareholders, the company or a combination thereof
  - Should the agreement consider issues with passive owners versus employee owners?
- Should the company have life insurance policies?
- Has the company considered other financial resources available to buy the shares?
- What are the terms of the transaction?
  - Down payment, interest rate, security
- Are there any restrictions on share payments under the company's loan agreements?

Other deficiencies in agreements include lack of signatures of all current shareholders, the agreement has not been updated for several years, the level of value is not defined or the valuation date is not defined.

One way to think about the review process is that most businesses have a profit sharing plan, such as a 401(k). If you participate in that plan, you want to know the current value of that plan on a periodic basis. If your buy/sell agreement states the formula or price is to be updated periodically, why wouldn't you review it often to ensure the agreement is being fair to all parties involved and working as desired?

As you can see, there are a number of potential issues that could result in your buy/sell agreement being a "ticking time bomb." Used properly, the buy/sell agreement is a great tool to provide direction for all kinds of triggering events that affect shareholders. We encourage you to discuss these matters with your shareholders, attorney and Eide Bailly service provider. ■

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Bidding on Financial Institutions—from page 1

An understanding of acquisition accounting under ASC Topic 805 is crucial in the preparation of pro forma financial information and projections. In general, assets acquired are required to be accounted for at fair value, so the valuation of assets is extremely important and usually very challenging. The FIL-30-2010, issued on June 7, 2010, provides additional guidance on bargain purchases and FDIC assisted acquisitions.

Selection of Winning Bid

The Least Cost Test is the method the FDIC follows in determining the winning bidder. The winning bidder is the bid that will be the least costly to the deposit insurance fund. If you are the winning bid, you will be notified only a few days before the actual bank closure takes place. The FDIC's bank closure process will be very structured. It is imperative that the institution's acquisition team is focused so that quick, confident decisions can be made to help ensure franchise value is preserved, employee morale lifted and confidence is instilled in the failed institution.

With the number of banks on the FDIC "Problem Institution List," there may be opportunities for an FDIC assisted transaction in your area. Understanding the bid process, having an acquisition strategy and a team of qualified advisors can help you make the most of the opportunity when it presents itself. ■

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OUT & ABOUT

Please join us in congratulating area bankers who were recently inducted into the Minnesota Bankers Association Pioneer Club. These bankers have worked in the banking industry for 50 years or more and have shown tremendous commitment to the industry and their communities.

Kathy Hallum
Rushford State Bank

Newman E. Olson Jr.
The First National Bank of Osakis

Jane Pickle
The State Bank of Kimball

Paul Tellefson
State Bank of Hawley

Wendale P. Vander Broek
State Bank of Chandler

Congratulations to all!

Time to Prepare for FACT Act Risk-Based Pricing

OVERVIEW

Compliance officers continue to be challenged with regulatory changes; with little time to prepare in many cases. Fortunately, the Fair and Accurate Credit Transactions Act of 2003 (FACT Act) Risk-Based Pricing Rules allows until January 1, 2011, to develop a strategy. On December 22, 2009, the Federal Reserve Board and the Federal Trade Commission published final rules implementing risk-based pricing provisions in section 311 of the FACT Act.

The FACT Act was implemented to enhance the consumer's ability to identify and mitigate his/her risk of becoming a victim of identity theft, increase the accuracy of consumer credit reports and to give the consumer added control.

The risk-based pricing notice requirements apply to financial institutions that use consumer credit reports in connection with applications for credit that are primarily for personal, family or household purposes; and the decision is based in whole, or in part, on the consumer credit report, resulting in credit granted under terms less favorable than the most favorable terms available. The regulation includes five optional model forms of risk-based pricing notices. "Materially less favorable" is defined as terms granted to a consumer that differ from terms granted to another consumer by the same financial institution that are significantly greater than the cost of credit to the other consumer. The requirements apply to credit extended to new and existing customers.

If the financial institution determines it is subject to risk-based pricing, a notice needs to be given to applicable consumers. On a case-by-case basis, the financial institution may determine if the consumer has received material terms that are less favorable. Since a direct comparison between consumers may not be feasible, the final rule provides two alternative methods for determining which consumers must receive risk-based pricing notices; (1) credit proxy method and (2) tiered pricing method.

The credit proxy method allows the financial institution to set the material terms of credit to determine a cutoff score, representing the point at which approximately 40 percent of its consumers have higher credit scores and 60 percent of its consumers have lower credit scores. The financial institution must provide a risk-based pricing notice to each consumer who has a credit score lower than the cutoff score.

The tiered pricing method allows the financial institution to set the material terms of credit by assigning each consumer to one of a discrete number of pricing tiers. This may be based in whole, or in part, on the consumer credit report. In this scenario, the consumers assigned to the lower tier(s) will receive the risk-based pricing notice. The number of tiers is dependent on the financial institution and the system it establishes.

The exceptions in the final rule allow, in some instances, for a credit score notice—similar to the credit score disclosure and Notice to Home Loan Applicant currently required on home loan applications—in lieu of the risk-based pricing notice. The financial institution must provide the credit score notice to every consumer requesting an extension or credit for a product utilizing risk-based pricing.

Now is the time to determine if your financial institution is subject to risk-based pricing notice requirements. Regardless of the outcome, you have time to plan. But don't delay! ■

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Levels of Assurance from a Credit/Lending Perspective

An important consideration for any business or non-profit organization lending relationship is the quality and quantity of information to request from the borrower. Should an organization rely on tax returns and internally generated financial statements, or request the involvement of a public accounting firm? If a decision is made to involve a public accounting firm, then what level of service should an organization request? There are three primary levels of service that can be requested from a public accounting firm: a compilation, review or audit. The following illustrates some key differences between these levels of service.

Compilation

A compilation consists of the accounting firm compiling financial statements from information received from company management. No assurance is offered on the information presented; and no inquiries, financial review or testing of accounting records is performed. The compilation report may contain complete footnote explanations of amounts and policies in the financial statements, or substantially all disclosures may be omitted. A compilation offers the lowest degree of assurance of the three service levels. As such, it is the lowest cost, in terms of accounting firm fees and internal labor for the borrower.

A compilation benefits the lending institution primarily by improving the quantity of information that is available, but not the quality, as no assurance is offered by this service. For unsophisticated borrowers, the inclusion of footnote disclosures and a statement of cash flows will likely offer the lender more information than would otherwise be available.

Review

During a review, the accounting firm reviews the financial statements and expresses limited assurance that no material modifications should be made in order for the statements to be in conformity with U.S. Generally Accepted Accounting Principles (GAAP). In order to express this assurance, analytical procedures are performed, such as ratio analysis, trending and prior period operations comparisons. Additionally, inquiries are made of company management and personnel regarding financial performance, operating results, industry expectations, and accounting policies and procedures. A review offers limited assurance on information quality at a cost that is higher than a compilation, but substantially lower than the cost of an audit.

A review benefits the lending institution by providing limited assurance on the quality of the information presented. In addition, similar to a compilation, the inclusion of footnote disclosures and a statement of cash flow in reviewed financial statements improve the quantity of information available—which can be significant to credit decisions.

Audit

An audit consists of the accounting firm issuing an opinion that the financial statements of the company or organization are free from material misstatements and are in conformity with GAAP. Audit procedures include obtaining an understanding of the entity's internal controls and business practices, assessing fraud risks and testing accounting records through confirmation, observation, analytical and other substantive procedures. An audit is the most costly service alternative, both in terms of accounting fees and the labor cost imposed on the borrower's

Levels of Assurance—continued on page 8

OVERVIEW

Due to the ongoing economic crisis, Federal and State financial institution regulators are requesting that loan officers obtain and analyze additional financial information from borrowers. In some cases, regulators may require financial information that has been compiled, reviewed or audited by an independent accounting firm. There are three primary levels of service that can be requested from a public accounting firm: compilation, review or audit. This article illustrates some key differences between these levels of service.

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RETURN SERVICE REQUESTED

Levels of Assurance—from page 7

personnel. However, it provides the highest level of assurance on the accuracy of the information presented.

Typically, an audit also assists borrower management with identifying process and control weaknesses, and offers suggestions for mitigation in order to improve the efficiency and effectiveness of operations. The information requirements of an audit can impose discipline on borrower personnel that improves the quality of interim financial information. An audit can also provide borrower personnel with a better understanding of the financial reporting process and improve the level of comfort management and the lender has over interim reporting.

If you have questions regarding which type of assurance is best for your institution, contact your Eide Bailly service provider. ■

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WE NEED YOUR INPUT

Participation Loan Survey

The recent economic downturn has had an impact on a number of banks with respect to loan participations. If your bank has experienced issues, please participate in our survey. It is the intent of this survey to inform participants of the experiences of other bankers, help clarify these challenges, identify areas in need of and banker motivations for better recovery solutions.

To participate, please visit our website at www.eidebailly.com/banksurveys.