



The American Institute of Certified Public Accountants (AICPA) held its National Conference on Banks and Savings Institutions in Washington, DC, on September 12-14, 2011. Once again, Dixon Hughes Goodman had a large contingent of Partners and Managers from our Financial Institution Services Group in attendance. The following are selected comments from various speakers at this year's conference that we felt were relevant and of interest. This summary does not capture all of the discussions presented over the three-day period; rather, the document is intended to highlight hot topics and recurring themes. The selected comments noted below are not quotes but rather our interpretation of the speakers' comments, which do not necessarily represent the opinion of Dixon Hughes Goodman.

Hot Topics and Recurring Themes

- Regulatory environment: Not only highlighting the significant increase in regulatory oversight and cost of compliance but also discussions on bank consolidation and obtaining the right size and scale to be successful in the future.
- Business combinations: With continued consolidation in the industry, the ongoing purchase accounting issues continue to grow in size and complexity.
- The allowance for loan and lease losses continues to garner much discussion. The U.S. and International standard setters continue to discuss the next generation allowance modeling and approach.
- Disclosure, Disclosure, Disclosure: Without a doubt, everyone wants to see increased disclosures on just about every topic. Credit Quality, Loss Contingencies, Fair Value, Liquidity, Interest Rate Risk and more.
- Troubled debt restructurings (TDR's): holdover theme from the last two years but now receiving a lot of attention in regards to increased disclosure and recent accounting guidance.
- And in regards to the economy, everyone seems to continue to see a long and slow recovery.

Selected Speakers and Comments of Interest

Evan Bayh, former US Senator and Governor of Indiana:

- Expects to see continued, if not increased, political volatility over the next couple of years.
- The path of least resistance at the federal level is to not cut spending and to not increase taxes. He could see the national debt continuing to increase until the market says "no more".
- He stated that he and Andy Card, former Bush chief of staff, are advocating for reasonable regulation.





James Kroeker and Craig Olinger, SEC Office of the Chief Accountant:

- The SEC continues to explore convergence with International Financial Reporting Standards (IFRS). The timing of full convergence is still up in the air.
- Frequent areas of comment from the SEC relate to:
 - Loss Contingencies – the nature, timing, possible range. The issues continue to arise from “surprise” charges (i.e., without appropriate foreshadowing) coming through the financials.
 - Non-GAAP measures – troubling trend of removing certain expenses from an earnings measure.
 - Business combinations – increased scrutiny of the discussion and disclosures.
- Made note of the recent update in August to the SEC reporting manual which can be found on-line on the SEC’s website.

Kathy Murphy with the OCC:

- Commenting overall on the allowance for loan losses (ALLL), she noted that while ALLL levels are at historic highs, the ALLL to net charge-offs is low.
- While credit quality overall appears to be stabilizing, commercial real estate and residential real estate continue to be weak. She emphasized being cautious with declines in the ALLL.
- In regards to agricultural lending, she noted that commodity and farm land values warrant monitoring due to current high levels.
- TDR’s (continued hot topic from prior years), continued need for documentation and having policies and procedures in place to monitor, evaluate and track. The impairment should “make sense” and reflect the uncertainty of the cash flows.
- Future of the ALLL: Noting that the FASB and IASB (International Accounting Standards Board) are re-deliberating their proposed credit impairment model and expect to issue for comment an alternative model. Impairment to be based on an expected loss model (not incurred) and dividing loans into 3 buckets: Good, Bad and Ugly. Stay tuned.

Bob Storch with the FDIC:

- Noted that there were 865 troubled institutions on the list at the current time. Expects there to be fewer closures this year and in the coming year.
- For TDRs with no reserves, why would you continue to assume full cash flows?
- Discussed the changed deposit insurance assessment base and that the intent of Congress was to shift a greater percentage of overall total assessments away from community institutions and toward large institutions.
- For new credit quality disclosures, do not mention regulators have agreed with the loan classifications.





Leases: Update on the FASB/IASB Project, David Reavy:

- The new lease accounting project, as it currently stands, would require a Lessee to recognize a right-of-use asset and a liability for estimated future lease payments on their balance sheet. For companies with significant leased facilities, this proposed standard could have a significant impact. Many banks also are the lessor and would be required to record a right-to-receive estimated future lease payments asset.
- All leases would be on the balance sheet with the exception of short-term leases.
- Significant issue in regards to ongoing “day 2” accounting and tracking system issues in order to comply with the new standard. Focus on establishing and maintaining a reliable lease inventory.

Catherine Lawton, Sandler O’Neill & Partners, an investment bankers view:

- This past quarter represented the first quarter of loan growth since 2008 and also the first reduction in problem banks since 2006.
- She expects significant ongoing consolidation within the banking industry. Expects the number of banks to drop by 2,000 or more in the next few years.
- While bank earnings have seen improvement, most of the improvement in earnings has been through reduced provisioning.
- Regulatory reform and the pace of economic recovery remain big variables. Structural problems in regards to household leverage and unemployment. Increased capital requirements, reduced fee income, and rising regulatory and compliance costs disadvantage those banks without sufficient scale.
- Size and capital strength will be key. Recommendation for community banks over the next 5 years: Get your balance sheets clean and determine what size you have to be to sufficiently absorb the higher costs of operations and the pressure on fee income.

Glenn Tompro and George Wilfert of the PCAOB:

- This presentation was aimed at auditors and inspection findings of the PCAOB as they relate to financial institutions.
- Allowance for Loan Losses: They want to see several areas improved in regards to supporting the ALLL: More detailed work surrounding fraud risks and internal controls. Auditors should consider results of bank examinations or in process exams. Thorough documentation and testing of significant assumptions and the underlying data. Consideration of problem loan monitoring.
- Auditors need to do a better job of auditing fair value measurements. Testing management’s significant assumptions, the valuation model, and underlying data. Developing independent fair value estimates. Not just relying on a third party to provide a value.
- Auditing litigation, claims, and assessments. This came up a few times during the conference in the context of identifying and disclosing loss contingencies.





Ask the Experts Panel on Community Banks:

- Troubled Debt Restructurings (TDR's). As in the past two years, there was a lot of continued discussion on TDR's, proper tracking and disclosure. Information needed on re-defaults of previously modified loans. Some are being asked to provide information on modifications NOT considered TDR's and what has happened with those loans.
- Compliance concerns due to the new regulatory regime. How large do community banks need to become in order to efficiently absorb the increasing costs of regulation.
- New allowance for loan losses modeling project. As mentioned by an earlier speaker on dividing the loan portfolio into 3 buckets: 1) not affected by current events, 2) should or could be affected, and 3) affected loan types. This approach would move to an expected loss model rather than an incurred loss model. The bucket approach is still in development. In regards to the timing of loss recognition, the markets favor taking immediate or up front recognition of losses.
- Proposed disclosures on liquidity and interest rate risk within the financial statements.

Douglas Duncan, Chief Economist for Fannie Mae:

- He felt that it was a coin flip as to whether or not we were in a recession. Consumers feel that they are in a recession no matter what. Employment activity is not matching economic activity.
- Small firms remain reluctant to hire. Job additions are not expected.
- This recovery is the weakest since World War I. Five more years to go to get through this recovery.
- Debt demand is and will continue to be weak.
- Bank consolidation continues as it has since the 1990's. The number of greater than \$10 billion size banks continue to increase significantly.
- Consumers will continue to deleverage. The recession impaired consumers' ability to qualify for credit.
- The shadow supply of housing remains high. While pending REO inventory and pending foreclosure inventory seem to have flattened out, the category of pending serious delinquency inventory within housing is very large.
- Banks are gradually reducing home equity lines from their balance sheets. However, the balance overall is still approximately 4 times greater than where it was in 2000.





Update from the SEC Division of Corporation Finance, Stephanie Hunsaker and John Donohue:

- Frequent areas of Staff comment:
 - Asset quality issues – 2nd lien loans, smaller community banks, TDR's and modifications.
 - Credit loss disclosures.
 - Transfers of non-performing assets off-balance sheet.
 - Loss contingencies.
- Significant discussion on second lien loans and how they work into the ALLL. Is the first lien performing?
- Typical comment themes with smaller community banks relate in large part to appraisals, modifications and TDR's, purchased credit impaired loans, and qualitative discussion about trends.
- For purchased credit impaired loans, how was initial FV determined and how were pools determined?
- Several comments relating to TDR's and disclosing specific modification programs that lead to TDR's and those that do not. They want to see transparent disclosure of details of modification or restructuring programs or activities. New disclosure requirements for TDR's, 3rd quarter for public banks.
- Common comments surrounding Credit Quality Indicators (CQI's):
 - Disclosed indicators are not at the same granular level as internal reporting.
 - Enhanced disclosure about how the indicators relate to likelihood of loss.
 - Disclosure about the updating or monitoring of Loan To Value ratios.
 - Lack of CQI's for consumer loans.
- Common comment surrounding Charge-off and Nonaccrual Policies: Lack of discussion about factors considered for loans that are not charged off when it is determined that they are impaired and an allowance is needed.
- Non-GAAP measures: this is generally mentioned every year but has received increased attention as registrants try to present their results in the best light possible. Should not refer to certain calculations such as Pre-tax, Pre-Provision earnings as "core" earnings.
- In regards to the use of pricing services, what does the bank do to validate the reasonableness of price obtained and to determine the classification in the fair value hierarchy.

Mortgage Banking Update:

- In regards to repurchase reserves, severity assumptions should use historical loss experience by vintage and by investor. Disclosures should be robust, including sensitivity analysis and possible (vs probable) range of loss.

Ask the Experts Panel on Large Banks:

- All substandard borrowers considered to be in "financial difficulty".

