



Bank Control Quarterly

"Through understanding, your bank can better control its financial performance..."

Nichols, Cauley & Associates, LLC
Certified Public Accountants
www.BankAudit.net
800-823-0117

3rd Quarter 2009

Spotlight



**Robbie
Eidson**
CPA, CIA

What are your primary financial institutions responsibilities?
*Internal / External Audits
and other consulting engagements*

How long have you been a part of the Nichols Cauley Team?
5 years

What designations do you hold?
*Certified Public Accountant
Certified Internal Auditor*

Where did you go to school?
Georgia Southern University

Where do you see yourself in 15 years?
Enjoying time with family & friends, hopefully with a family of my own and still providing valuable service to our clients

What is your favorite pastime?
Spending time with friends and family

If you could go on a free vacation where would it be?
Italy

Who is in your family?
Just me...

TAX TREATMENT OF SILVERTON STOCK & TRUST PREFERRED SECURITIES

The recent demise of Atlanta's Silverton Bank has substantially impacted the banking industry. Particularly it has produced a negative impact on the Georgia market, as many community banks were invested in Silverton stock and trust preferred securities. The failure of Silverton Bank not only impacts the balance sheet of many smaller banks, but also presents tax consequences which must be considered. The losses resulting from the worthlessness of Silverton Bank securities may either be classified as ordinary or capital for federal income

tax purposes depending on the particular situation of the holder.

The following is a general summary of the tax treatment for these losses for a **Bank**. However, you should seek professional guidance to deal with your individual situation.

Silverton Common Stock

Unfortunately, the loss on Silverton common stock for the majority of banks results in a **capital loss**. This is an equity interest to the bank, acting as an investor, and is deemed to be a capital asset. The Silverton common stock is not a debt instrument and most likely does not fall into the bank exemption category in order to be treated as an

(Continued on page 2)



Sarah Collins



Tim Veal
CPA, CITP, CIA, CISA, CFP®



Dave Musser
CPA, CIA, CFP®

DEFERRED TAX ASSETS - VALUATION AND THE EFFECT ON THE BANK & REGULATORY CAPITAL



Hunter Fountain

One of the hot topics today, and in the future, is the impact of deferred tax assets on a bank's capital. A deferred tax asset is a temporary difference created between book accounting basis and tax accounting basis that will result in a future taxable benefit. The most common deferred tax asset for a bank is the difference in the book deduction for the provision for loan losses from net income and the provision amount al-

lowed to be deducted for tax purposes. Generally, book provision exceeds the tax provisions due to the fact that the tax deduction is based on actual charge-off history, therefore, any excess book provision creates a deferred tax asset.

When a bank records a deferred tax asset, which will off set future benefits, the bank must also consider the need for a valuation allowance for the asset. The valuation allowance is provided for any portion of the deferred tax asset when there is more than a 50% likelihood the asset will not be

(Continued on page 3)

A Sweeping Overhaul

Charles Darwin is quoted as saying, “it is not the strongest of the species that survives, not the most intelligent, but the one most responsive to change.” In the wake of the worst crisis to hit Wall Street in over seventy years, President Barack Obama proposed a “sweeping overhaul” of the United States financial system on June 17, 2009. This plan unveiled measures that will inevitably bring about vast changes to the banking and financial industry through increased oversight, transparency and accountability. As a result, institutions will be required to abide by new regulations that Congress is expected to pass by the end of the year. The two most highly contro-

versial elements of the plan are the increase of power for the Federal Reserve and the creation of the Consumer Financial Protection Agency.



Both the Federal Reserve and the Treasury will be granted expanded authority under the new proposal. The Federal Re-

serve will gain power to supervise all firms that could pose a threat to the nation’s financial stability. Alongside the Federal Reserve, a new Financial Services Oversight Council of financial regulators will be created in order to monitor and identify emerging financial risks. This council will be situated in a manner that allows it to prevent and detect failures like those of AIG and Lehman Brothers. Furthermore, the Treasury will also gain veto power over the Federal Reserve’s decision to extend emergency finances to companies on the verge of collapse.

In order to protect consumers against fraud and to promote greater understanding of financial instruments like credit cards and mortgages, President Obama’s plan calls for the creation of the Consumer Financial Protection Agency. This agency will have the ability to monitor and protect consumers across the financial sector from unfair, deceptive and abusive practices, such as subprime and nontraditional mortgages.

In addition to the augmented authority of the Federal Reserve and the creation of the Consumer Financial Protection

Agency, the plan also proposes:

- * Mandating increased capital levels at institutions in order to prevent over leveraging.
- * Abolishing the Office of Thrift Supervision and merging duties into the Office of the Comptroller of the Currency.
- * Increasing supervision of the securitization markets by requiring firms that originate a security to retain a five percent stake in the security.



Josh Grant

As the banking and financial industry continues to tread on uncertain ground, one thing is for sure, *change is coming*. Remember, it is not the strongest of the banks that survives, not the most intelligent, but the ones most responsive to change.

Please visit www.financialstability.gov for more information pertinent to the proposed financial regulatory reform.

Silverton Stock (Continued from page 1)

ordinary loss.

An exception exists if you were a deemed dealer in securities (including Silverton stock) and included the stock in an election to be treated as such; then it would be treated as an ordinary loss. This is the exception and not the general rule and requires compliance with various Internal Revenue Code Sections from the initial purchase date of the common stock.

Silverton Trust Preferred Securities

Now the good news (if there is any good news that can come out of this situation), for a bank that carries the Silverton trust preferred securities in its investment portfolio, the bank is afforded favorable tax treatment, and the loss is classified as an **ordinary loss**. The trust preferred

security is a debt instrument and affords the same tax treatment for a bank as the sale or exchange of a bond, debenture, or other indebtedness.

Non-Banking Institutions

Non-bank holders of Silverton securities face a different set of rules than banks holding Silverton securities or other types of securities. For non-banking institutions holding Silverton stock and trust preferred securities, the tax rules are less favorable than those for banking institutions, as capital loss treatment will most likely result. The only time an ordinary loss may result from a non-banking institution’s loss on bank securities is if the institution is considered to be a dealer (as mentioned above), and the security is *not* held for investment purposes.

Summary

Once the type of loss has been deter-

mined, the organization’s structure determines how the loss is handled. For a C Corporation, a capital loss may only be used to offset a capital gain. The **capital loss** may be *carried back three years and/or carried forward five years*, if not used in the current year. If the **ordinary loss** creates or adds to a net operating loss, it may be *carried back two years and forward twenty*. For an S Corporation, both a capital and ordinary loss will retain their form and pass through to the shareholders.

Applying the above loss classification rules may become quite complicated in practice and will require the assistance of a tax professional. If you would like additional information on the tax treatment of Silverton securities please do not hesitate to contact Dave Musser or Cal Brantley.

Deferred Tax Assets (Continued from page 1)

realized. Recognition of the deferred tax asset is difficult and can be affected by many factors including:

- * The ability of the entity to earn sufficient income to allow recognition of the deferred tax asset
- * Expiration dates of the accumulated values of the deferred tax asset

The determination of whether a valuation allowance is necessary under GAAP should be done in accordance with the provisions of SFAS No. 109. SFAS No. 109 requires that both positive and negative evidence be considered when determining whether the deferred tax asset is more likely than not to be realized. An example of positive evidence would be strong earnings with the exception of current loss that creates a net operating

loss carryforward. Negative evidence would include cumulative loss history, questions about an entity's ability to continue and loss carryforwards expiring unused. The existence of negative evidence does not automatically mean a valuation allowance is necessary, however, it could make it difficult to conclude that at least certain portions of the asset will not be realized.

Additionally, banks must consider the regulatory impact of deferred tax assets. Regulatory agencies have limited the amount of the net deferred tax assets which can be included in regulatory capital calculations. Management should refer to CALL report instructions related to line item RC-R 9b.

Overall, a general rule of thumb is the deferred tax asset included in regulatory capital cannot exceed the lesser of 10%

of the core capital or the amount of tax on your next twelve months of taxable income. Since the creation of a deferred tax asset increases equity through retained earnings, regulatory authorities seek to ensure regulatory capital is not overstated based on an asset which may not be realized by a troubled institution.

Based on the current economic environment in which banks are operating, we recommend banks evaluate the need for a valuation allowance on its deferred tax assets and the potential impact to capital. This is a complicated topic that can require professional assistance. Please contact Nichols, Cauley & Associates, LLC regarding your deferred tax assets.

Don't be caught off guard!

Fraud in the Current Economic Environment

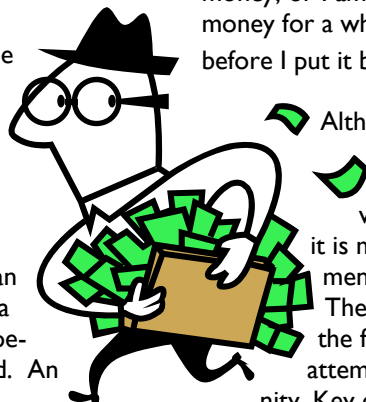
As the economy continues to struggle and companies continue to downsize, management should be aware of the increased potential for fraud amongst its employees. The ever popular Fraud Triangle outlines three factors which are key ingredients for an employee contemplating a fraudulent act: Incentive/Pressure, Opportunity and Attitude/Rationalization. If all are present, the recipe could spell disaster.

Incentive/Pressure could be a number of things including fear of job loss, mounting unpaid bills at home or unforeseen life events.

Opportunity arises when an employee has been put in a position to be able to perpetrate and conceal the fraud. An example would be an employee who writes checks, has the ability to sign the checks and also reconciles the bank statement. While this is the classic example, many more are much less noticeable and can lead to harsher losses. This is why segregation of duties is of the

utmost importance.

Lastly is the attitude/rationalization element. This factor allows the employee to justify his/her fraudulent actions because of some idea that the fraud is warranted. Examples could include: I did not get a pay raise or bonus this year, and the company owes it to me; the company is considering laying me off and I need the money; or I am only going to borrow the money for a while and no one will notice before I put it back.



Although detective controls such as internal controls and management supervision are very important, it is more important to implement preventive controls.

These controls help to stop the fraud from occurring or attempt to deter the opportunity. Key controls include, but are not limited to, employee support programs, segregation of duties, employee background checks, and a whistle blower hotline that other employees can call and report suspected wrongdoings. Other ways employers can attempt to deter

Jason Dollar, CPA, CIA



fraud is to increase the perception of detection. Most fraudsters will engage in illegal activities only when they have a perception that there is an opportunity to reduce whatever pressures they are facing without getting caught. If the organization can change the perception in its employees' minds that fraud will be detected, it could significantly deter the act.

Employers should take notes of employees' personal lives or observe changes in behavior that could lead to an incentive to commit fraud and then attempt to determine if the individual would have any opportunity to carry out the act. Employers should also keep up-to-date on new fraud schemes by following recent news events dealing with the subject. But most importantly, employers should implement a strong internal control system, which would not only deter fraud, but would also bring it to light quickly in the case fraud were to occur.



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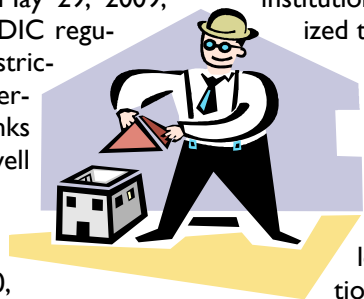
FDIC to Cap Interest Rates



Kyla Milton

Due to the recent downturn in the economy and the added pressures applied to financial institutions across the nation, the Board of Directors of the Federal

Deposit Insurance Corporation (FDIC) issued a final rule on May 29, 2009, changing the way the FDIC regulates its statutory restrictions on the deposit interest rates paid by banks that are less than well capitalized.



Effective January 1, 2010, the FDIC will regularly publish national rates and caps on their website. This will replace the previous national and local rate

regulations. National products will no longer use the maturity Treasury yield. Instead the FDIC will issue a nationally prevailing rate as a result of direct calculation of national averages. The rule also states that locally prevailing deposit rates are equal to the national rates published by the FDIC. Since an undercapitalized institution may not accept brokered deposits under any circumstances, the rule will also allow institutions that are less than well capitalized to utilize these rates as a safe harbor for complying with the statutory interest rate restrictions by allowing these institutions to offer services 75 basis points above the national average. If the market averages for that institution's local rates are higher than the national average posted, then the institution will have the opportunity to offer their products at 75 basis points above the local market.



We are often asked if we have time to serve additional clients. We are a progressive firm, and we appreciate your referrals. If you are pleased with our services, please mention us to your friends and business contacts.