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COMMUNITY BANKING ADVISOR



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KEEPING PACE WITH INTERNAL AUDIT

The role of the internal audit has been evolving from that of a compliance and fraud watchdog to that of a full-fledged partner in an institution's overall risk management process. In light of this development, all community banks should review their internal audit (IA) programs to ensure that they're meeting their risk management needs.

WHY THE CHANGE?

Many institutions recognize that internal audit, with its intimate knowledge of the organization and its operations, is uniquely positioned to identify and evaluate a bank's risks and its risk management activities. Plus, banking regulators are placing greater emphasis on risk management and the critical part IA plays in the process. For example, in 2014, the Office of the Comptroller of the Currency published its *Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of Regulations*.

BANK REGULATORS ARE PLACING GREATER EMPHASIS ON RISK MANAGEMENT AND THE CRITICAL ROLE INTERNAL AUDIT PLAYS IN THE PROCESS.

Community banks aren't *required* to follow the guidelines. Nevertheless, they represent best practices for well-managed banks and are likely to shape examiners' expectations. To enhance their risk management



programs, community banks should consider incorporating the guidelines — adjusted as appropriate for their size and risk profile.

WHAT DO THE GUIDELINES REQUIRE?

Covered banks must establish and implement a written risk governance framework that addresses credit, interest rate, liquidity, price, operational, compliance, strategic and reputational risk. They provide detailed guidance on the relative roles and responsibilities of a bank's "front line" business units, independent risk management and IA.

The responsibilities of the IA function include:

- ▶ Ensuring that the framework complies with the guidelines and is tailored to the bank's size, complexity and risk profile,
- ▶ Maintaining a current inventory of material processes, product lines, services, and functions, and assessing the risks associated with each,

- ▶ Implementing an audit plan — periodically reviewed and updated — that takes into account the bank’s risk profile and emerging risks and sets the frequency with which activities should be audited,
- ▶ Providing written reports to the audit committee on the conclusions, material issues, recommendations and other information revealed by its audit work,
- ▶ Implementing processes for independently assessing — at least annually — the design and ongoing effectiveness of the framework, and
- ▶ Informing the board or audit committee of significant deviations from the framework.

An internal audit also should establish a quality assurance program to ensure that its policies, procedures and processes: 1) comply with applicable regulatory and industry guidance, 2) are appropriate given its size, complexity and risk profile, 3) are updated to reflect changing risk factors, emerging risks, and improved audit practices, and 4) are consistently followed.

IN-HOUSE OR OUTSOURCED?

It’s important for banks to decide whether to run an IA program in-house or to outsource it to a public accounting firm or other professional organization. Some advantages of outsourcing: It gives a bank access to expertise or specialized audit tools that may be difficult or cost-prohibitive to maintain in-house. It also allows a bank to avoid the fixed labor and overhead costs associated with an in-house IA department and to easily adjust its “staff” as needs fluctuate. Plus, external consultants are often perceived as possessing greater independence, which may lend credibility to the internal auditors’ findings.

A disadvantage of outsourcing is that external consultants may lack the in-depth knowledge that in-house staff possess. One potential solution is to outsource IA to the bank’s external auditor (provided the bank isn’t subject to SEC rules). Even if permitted, however, the bank should weigh the potential benefits of using the

MANAGE THE RISKS OF OUTSOURCING

Over the last few years, most federal banking agencies have published guidance on managing outsourcing risks. The guidance requires banks to develop a formal plan for managing third-party relationships, conduct thorough due diligence on prospective providers, negotiate contracts that clearly spell out each party’s rights and responsibilities, monitor the relationship, and perform periodic independent reviews of the third-party risk management process.

Also, in 2013, the Federal Reserve issued its *Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing*. Although the statement doesn’t apply to community banks, it provides valuable guidance on managing outsourcing risks. It also emphasizes that the board and management remain responsible for IA, and requires a written agreement that clearly outlines the respective roles and responsibilities of the bank and the IA firm.

Banks should develop policies and procedures for selecting competent internal audit vendors and overseeing their work, have a contingency plan in the event of any disruptions in service, and ensure that a vendor’s work meets the quality standards expected of an in-house IA department.

same firm for both internal and external audit against the risk of deflating the external auditor’s independence.

For banks that opt for an outsourced solution, it’s critical to follow the federal banking agencies’ guidance on managing third-party risk. (See “Manage the risks of outsourcing” above.)

REVIEW YOUR PROGRAM

If you haven’t reviewed your internal audit program lately, you should make that assessment. The importance of risk management — and IA’s role in the process — will only continue to grow. ■

Your borrowers' statement of cash flows

FASB PROPOSAL CLARIFIES ITS GUIDANCE

In a new proposal, the Financial Accounting Standards Board (FASB) attempts to clarify several parts of its guidance on company cash flow statements. The move could take some of the guesswork out of your business customers' financial statement preparation as well as reduce their number of restatements.

Proposed Accounting Standards Update (ASU) No. EITF-15F, *Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments*, issued January 29, 2016, is the first of two planned proposals regarding cash flow statements. A second proposal, also to be discussed this year, will clarify how to classify and present changes in restricted cash on the statement of cash flows.

According to the FASB, company reporting errors about cash flow reporting have been among the top causes of financial restatements. The standards board hasn't said when they expect the new guidance, if finalized, to take effect.

LENDERS SHOULD BE AWARE

As a lender, you should understand how the statement of cash flows works, where potential missteps are likely to take place, and how the proposal, if approved, would affect the picture of cash flows that your borrowers are painting. The statement can provide valuable insights into their ability to repay loans.

THE STATEMENT COMPRISES THREE SECTIONS

The statement of cash flows customarily shows the sources and uses of cash and its equivalents. Under Generally Accepted Accounting Principles, it's typically organized into three sections.

The first section — cash flows from operations — starts with accrual-basis net income. Then it's adjusted for items related to normal business operations, such as gains (or losses) on asset sales, depreciation and amortization, income taxes and net changes in accounts receivable, inventory, prepaid assets, accrued expenses and payables. The end result is cash-basis net income, which is the cash provided (or used) in the process of producing and delivering goods or providing services. Beware of borrowers with several successive years of negative operating cash flows.

If a company buys or sells property, equipment or marketable securities, the transaction shows up in the second section: cash flows from investing activities. It reveals whether a borrower is reinvesting in its future operations — or divesting assets for emergency funds.

The third section describes cash flows from financing activities. This section shows the company's ability to obtain cash via either debt from lenders or equity from investors. It includes new loan proceeds, principal repayments, dividends paid, issuances of securities or bonds, and additional capital contributions by owners.

Capital leases and noncash transactions are reported in a separate schedule at the bottom of the statement of cash flows or in a narrative footnote disclosure.



CLASSIFICATION DECISIONS CAN BE CONFUSING

Guidance on classification decisions is provided by Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows* (Topic 230). Although this statement was issued in 1987, classification among operating, investing, and financing activities remains a gray area.

Bank personnel have been especially confused about how to classify transactions that have aspects of more than one type of activity, such as taxes paid on investment gains, redemptions of employee stock options, sales of receivables, and dividends received from investments, installment sales and purchases. Sometimes it's unclear from the guidance whether the cash flow should be split into two activities or allocated to one specific activity. External accounting advisors can provide guidance when borrowers are uncertain.

GRAY AREAS ADDRESSED

The FASB proposal covers eight areas, including debt prepayment or debt extinguishment costs, the cash payment attributable to accreted interest on zero-coupon bonds and the proceeds businesses receive from corporate-owned life insurance. The proposal also addresses one of the most complicated parts of cash flow presentation, which is a concept that accountants call the "predominance principle." To see the full proposal, go to FASB.org and click on "Emerging Issues Task Force (EITF)" under "Quicklinks."

STAY CURRENT

Lenders need to keep informed about requirements for preparing the statement of cash flows. Your being up to date on the matter will improve your due diligence efforts when you evaluate borrowers. ■

TO ATTRACT AND RETAIN MILLENNIALS, FOCUS ON DIGITAL CHANNELS

 Millennials have overtaken Baby Boomers to become the largest population segment in the nation. More than 75 million strong, this group — also known as Generation Y — generally consists of people in the 19-to-35 age bracket.

To build lasting relationships with Millennial customers, banks must understand this generation's distinctive characteristics and needs. In particular, Millennials tend to use a wide range of devices and channels to interact with their banks — for banking transactions as well as customer service — including mobile apps, bank websites, texting and social media. Investing resources in developing and marketing these digital

channels is critical to attracting and retaining this important demographic group.

OPPORTUNITIES AND RISKS

According to a recent Fair Isaac Corporation (FICO®) survey, most Millennials (68%) use banks with a national presence as their primary banks, with only 15% using credit unions and 9% using regional banks. Millennials are more likely than older generations to use a large national bank as their primary institution, and tend to have more products at those banks. But they're less loyal than other customers. FICO reported that Millennials are five times more

likely than those over 50 to close all of their accounts and three times more likely to open a new account with a different bank.

For community banks, this presents both an opportunity and a risk: The willingness of Millennials to switch banks makes them an attractive target for new customer acquisition campaigns. At the same time, their lack of loyalty places community banks at risk of losing their own Millennial customers.

So, why do Millennials choose to switch banks? According to FICO, the top reason is excessive service fees, followed by negative experiences with bank representatives and ATM issues (too few, inconvenient locations, excessive fees). In addition, unsatisfactory digital experiences (both online and mobile) have a much bigger negative impact on Millennials than on other demographic groups.

MAKING THE MOST OF TECHNOLOGY

One key to satisfying Millennials is to offer multiple channels and devices for interacting with the bank and to ensure that communications and customer experiences are consistent and seamless across all channels. In addition to online banking and mobile apps, other examples include live chatting via a bank's website or mobile app, two-way texting with customer service representatives, and social media

(such as Twitter and Facebook). Some banks are even offering video chatting capabilities on ATMs.

FICO also makes some generalizations:

- ▶ Millennials are much more likely than other age groups to use mobile banking apps (although they still prefer to use a bank's website).
- ▶ Frequent mobile app users are more satisfied with their banks and more likely to recommend their banks to others.
- ▶ A positive service experience is "a clear driver" for Millennials to recommend their banks to others.
- ▶ Millennials are more likely to prefer texting for bank communications, particularly for things such as credit limit warnings and notifications of suspicious charges.

The survey also found that, for Millennials, social media recommendations are much more valuable sources of marketing information than they are for other generations.

SPREADING THE WORD

To attract and retain Millennials, banks should explore options for enabling these customers to use their preferred communication methods. Texting, in particular, is an underused channel that Millennials desire. Banks also should leverage Millennials' willingness to recommend them by developing social media platforms, "sharing" tools in mobile and Web-based apps, and "tell-a-friend" incentives. ■



FASB UPDATES GUIDANCE ON CLASSIFYING AND MEASURING FINANCIAL INSTRUMENTS

Banks will be required to measure certain equity investments at fair value and recognize fair value changes in net income, due to an update from the Financial Accounting Standards Board. Accounting Standards Update (ASU) 2016-01, *Financial Instruments—Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities*, also eliminates the “available for sale” classification, under which changes in fair value are reported in “other comprehensive income.”

Additionally, the ASU provides some financial reporting relief for many community banks — it ends the requirement for nonpublic business entities to disclose the fair value of financial instruments measured at amortized cost, such as loans and deposits. Although the guidance doesn’t take effect until fiscal years beginning after December 15, 2018 (2017 for public business entities), this provision may be adopted early. ■

WHY YOU NEED A BYOD POLICY

Given the usefulness and pervasiveness of smartphones and other mobile devices, it’s wise for banks to establish a “bring your own device” (BYOD) policy. Some banks — concerned about security risks — simply prohibit employees from using their own devices for bank business. Such a ban can be unpopular as well as difficult to enforce, however. A less stringent approach would be to have a policy that permits the use of mobile devices, but also takes steps to manage the risks.

A BYOD policy should:

- ▶ Provide for management approval of devices,
- ▶ Require employees to use strong passwords and other security controls,
- ▶ Enable the bank to wipe a device remotely at its discretion,



- ▶ Specify the types of information that can be stored on — or transmitted using — the device, and
- ▶ Establish encryption standards.

Certain vendors offer mobile device management solutions that banks can use to manage employees’ devices and implement controls to protect bank information. ■

LOW NET INTEREST — “NOT THE NEW NORMAL”

The Federal Reserve has attributed recent low net interest income to low interest rates, fewer lending opportunities and relatively flat yield curves in the years following the financial crisis and recession. But low net interest income “isn’t the ‘new normal,’” the Fed stated in its *Community Banking Connections*. The agency predicted that, “although net interest income may be unlikely to return to the high levels of the early 1990s, as the economy improves net interest income is likely to rebound significantly.” ■

CFPB OFFERS SOME GUIDANCE ON CONSTRUCTION LOAN DISCLOSURES

The Consumer Financial Protection Bureau recently published a fact sheet (“Know Before You Owe Mortgage Disclosures and Construction Loans”) explaining construction loan disclosures under the TILA/RESPA Integrated Disclosure rule. At consumerfinance.gov, click on “Law & Regulation” > “Regulatory implementation” > “TILA-RESPA Integrated Disclosure rule” to reach the “construction loan factsheet” link. ■

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