

SQUAR MILNER

COMMUNITY BANK NEWS



Issue 1

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Squar Milner's Financial Services

Our full range of services include audit, tax, business risk consulting and transaction due diligence. Squar Milner's dedicated financial services industry professionals have extensive backgrounds serving a broad range of public and private financial institutions. Our Financial Services Industry is organized within three divisions to better serve our clients:

- Banking
- Specialty finance
- Asset management

Coming in Next Issue:

Securitization recharacterization - restructuring SPE's to remove loans and debt from your balance sheet

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California Real Estate Crisis... How will it affect community banks?

It's page one news every day. Housing prices are declining. Foreclosures are increasing. Subprime lending has ruined the global financial community and financial stocks are taking a beating. The Federal Reserve has drastically reduced interest rates and it appears that the US economy is either in or headed for a recession. The latest national news is that everyone in the country was living too well on too much borrowed money and now is the time to pay it all back.

Analyzing the realities of the situation is far less dramatic. Here in California, the most

populated state in the nation, we have indeed felt the impact of the decline in real estate values, but basic econometrics tend to support long term stability rather than panic.

California is most fortunate to have a diverse economic foundation. Agriculture, high tech businesses, entertainment, light industry, manufacturing, and banking provide a platform for sound economic growth. Although the state is suffering a financial crisis caused primarily by overspending on government programs, steps are indeed being taken to reduce expenditures and increase revenues.

Few, if any, community banks have engaged

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Should Your Bank Change Auditors?

YOUR BANK CHANGES... SHOULD YOUR AUDITOR CHANGE?

Community banks in California change faster than banks in any other state. They expand their scope of customer services, increase their sources of gross revenue, try more tools to deal with interest rate risk, add branch facilities, and underwrite more complex lending arrangements in very short time frames. Compared to their peers in the mid-west and on the east coast, California community banks embrace a much higher level of sophistication and complexity, much more like larger regional financial institutions. As a result of this phenomenon, they are in virtually perpetual need of expert financial advice. As they change, better manage risk, and need to know more about managing their evolving bank, they want their advisors to be there to clearly help them on a proactive basis.

AUDITORS' RULES HAVE CHANGED... WHAT'S NEW?

The demise of Arthur Andersen, once the world's largest accounting firm, forever changed the accounting profession. It shook up the way auditors performed their audits and changed their audit approach. More importantly, it redefined the need to independently analyze their client's transaction economics and risk. Some say it redefined the auditor/client relationship. Once the dust settled, the new rules required auditors to first carefully and critically assess the integrity of their client's management and then "dig into" a client's sources of revenue, to ascertain if "earnings" were truly real!

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Should Your Bank Change Auditors? (continued)

PRACTICING UNDER THE NEW AUDIT RULES - CPA FIRMS HAVE ISSUES

The new auditing rules require more in-depth analysis, but many large and mid-size accounting firms have a staffing dilemma. They have some experienced audit partners, few middle level audit managers and lots and lots of inexperienced professional audit staff. Professional audit personnel capabilities vary dramatically. To better cope with this situation, larger firms have developed a "template" audit approach methodology. The template risk management technique is designed to "pre-think" nearly all potential audit risks for a particular industry, and put it into a lengthy series of questions, and grids that can be completed by inexperienced audit personnel. Once the data is captured

and accumulated, more qualified audit personnel can then go over the data and ascertain if the audit approach is truly addressing all auditor concerns.

From the client's perspective, the template approach results in the preparation of much larger volumes of data that is delivered to inexperienced independent auditors, so that they may catalog it and then ship it up to more experienced auditors for review and analysis. It also means that auditor field personnel are not only unfamiliar with auditing but also community banking. So, for the most part, they are not a viable resource for answering any client questions.

WORRYING ABOUT INDEPENDENCE?

Over the past few years, some CPA firms have been overly concerned with the proliferation of the evolving auditing rules that stress "auditor independence." Many mid-tier CPA firms have become extremely apprehensive about giving their views on questions asked of them by their clients on operational and/or policy matters for fear of jeopardizing their auditor independence.

The result is many auditing firms no longer are the primary resource that a community bank turns to for operational and financial and tax planning advice. This is most unfortunate.

The community bank's once most trusted advisor, their CPA firm, has become a data gatherer and a policeman rather than an advisor. Many auditing firms are so afraid of ever being accused of engaging in influencing management decisions that they would rather not know about management decisions until after they have been independently made by bank directors and management. This seems foolish since this lack of knowledge often results in lots of last minute auditor adjustments, back end inquiries for further explanation and even critical evaluations of client internal controls.

IS THIS WHAT THE RELATIONSHIP WITH YOUR CPA FIRM HAS BECOME?

If any of this sounds all too familiar to you, then perhaps its time for a change of auditors, to a firm that is more concerned with building client relationships and serving your needs than safeguarding their own image and reputation.

Although every audit firm must follow the new risk assessment standards, smaller, better managed CPA firms do have a distinct advantage. Since they have fewer clients in fewer industries and devote more partner time to

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each audit and tax client, they tend to be more available and closer to their clients. Thus there is no need for them to adopt the large firm template risk management methodology. Smaller firms also have the ability to hire professional audit staff that want to stay in public accounting. Many audit staffers join smaller firms after leaving a larger firm because they are in search of better qualified partners, closer hands on supervision, faster promotion and greater advancement potential.

Should Your Bank Change Auditors? *(continued)*

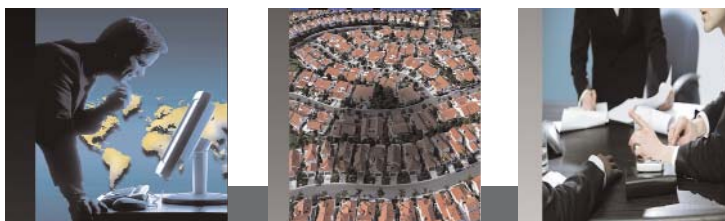
EXPERIENCE, ATTENTIVENESS, & CARE = VALUE

The community bank audit committee chairman should annually evaluate the performance of their independent auditors. Do they get the work done on a timely basis? Is the partner on the job communicating frequently with the audit committee and bank management? Does bank management think that their field personnel know what they are doing? Is the scope of the audit focusing upon current and relevant economic risks-or are they simply following a boiler plate annual audit program? Is the partner on the job regularly checking on their field personnel performance by coming to the bank? Is the audit partner aware of current "hot topics" important to the regulators? Does the audit committee chairman feel that the bank is getting the best client service possible?

THE BOTTOM LINE

Changing auditors permits shareholders, regulators, the board of directors, and bank management to be exposed to a new viewpoint. It disrupts legacy thinking and allows for an independent and fresh risk based examination of current bank operations, accounting policies and procedures, planning, and strategic thinking. Often it can result in enhancing the integrity of the bank's financial results and reliability.

Getting the best available combination of audit advice, tax advice, financial counsel, and accounting talent is good for all.



California Real Estate Crisis...

(continued)

How will it affect community banks?

in subprime consumer real estate lending. Many community banks have significant proportions of their loans in commercial real estate loans to the owners and operators of small businesses, custom home construction loans, small infill condominium projects, and low LTV (loan to value) home equity loans.

No one group of lenders is immune to declines in real estate values, but unlike the savings & loans of the 1980's there has not been wide spread run-away speculation and development of diverse income producing real estate projects, (resort hotels, high rise office buildings, large shopping centers, etc.) in remote markets that were funded by 100% LTV loans!

Because of changes in appraisal criteria, controlled and prudent loan underwriting, better regulatory supervision, high levels of capitalization, and competent management, commu-

nity banks are more stable than ever before. Over the past 10 years, California real estate values have spiraled to unrealistic levels. Recognizing and fueling the rise, high risk lenders relied on this phenomenon to create securitized lending instruments secured by unsound inflationary based underwriting criteria. (See next issue where we discuss the process of achieving securitization recharacterization accounting to remove loans and debt from your balance sheet and record the fair value of beneficial interests.) When real estate prices leveled off, they became 100+% LTV loans that quickly headed for default.

Financial prudence dictates that community bankers reexamine and reevaluate collection risks in their loan portfolios, and carefully stress test the impact of declining real estate values. Many new techniques are now available that make this much easier than ever before; we can acquaint you with them. Give us a call.