Acquisition Accounting: Day Two Issues

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Agenda

• Business Combinations
  ➢ Management Responsibilities
  ➢ Day 1 Accounting
  ➢ Day 2 Accounting
  ➢ Challenges
  ➢ FDIC Assisted Transactions and Loss Sharing Agreements
  ➢ Regulatory Reporting and Guidance
Business Combinations

Management Responsibilities

• Management responsibilities

  ➢ Plan
  ▪ Accounting guidance
    – Day 1 vs. Day 2
    – Measurement period
  ▪ Loss Sharing agreement requirements
  ▪ Operational considerations
    – Chart of Accounts
    – Integration
  ▪ Staffing
Business Combinations
Management Responsibilities (Cont’d)

• Accounting guidance
  ➢ ASC 805 (formerly SFAS 141(R))
  ➢ ASC 820 (formerly SFAS 157)
  ➢ ASC 815 (formerly SFAS 133)
  ➢ ASC 310-20 (formerly SFAS 91) unimpaired loans
  ➢ ASC 310-30 (formerly SOP 03-3) impaired loans
ASC 805 requires the application of the acquisition method to all business combinations, including assisted acquisitions. The acquisition method entails:

1) Identifying the acquirer;
2) Determining the acquisition date;
3) Recognizing and measuring the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree; and,
4) Recognizing and measuring goodwill or a gain from a bargain purchase.

Generally, these steps require the exercise of significant judgment.
Day 1 Accounting
Business Combinations

Day 1 Accounting

• Day 1: Fair value assets acquired and liabilities assumed
  ➢ Valuation techniques required due to illiquid nature and lack of quoted market prices
    ▪ Appropriateness of inputs
    ▪ Appropriate selection and use of valuation technique
  ➢ Based on market participant’s view
  ➢ Determination of Goodwill or Bargain Purchase
Business Combinations

Day 1 Accounting (Cont’d)

• Day 1: Loans

➤ Choice of following ASC 310-20 (formerly FAS 91) or ASC 310-30 (formerly SOP 03-30)
  ▪ ASC 310-20 – accrete entire discount into income over expected life of loan
  ▪ ASC 310-30 – accrete discount not related to credit risk into income over expected life of loan
  – must comply with all accounting and disclosure requirements

➤ This is a permanent decision
### Example of Combination

<table>
<thead>
<tr>
<th>Description</th>
<th>(000’s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Equity of Failed Bank and Cash from FDIC</td>
<td>95,100</td>
</tr>
<tr>
<td>Investment Securities</td>
<td>(2,500)</td>
</tr>
<tr>
<td>Loans</td>
<td>(213,500)</td>
</tr>
<tr>
<td>Foreclosed real estate</td>
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</tr>
<tr>
<td>FDIC Indemnification asset</td>
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<tr>
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<tr>
<td>FHLB Advances</td>
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</tr>
<tr>
<td>Core deposit intangible</td>
<td>3,000</td>
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<td>Other adjustments</td>
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Day 2 Accounting
Business Combinations

Day 2 Accounting

• Day 2: Accounting and Reporting
  ➢ Gather same level information as Day 1
  ➢ Data integrity
  ➢ Separation of originated and acquired assets
  ➢ Measurement period
    ▪ Adjustments to fair value based on facts and circumstances that existed at the acquisition date
  ➢ Internal training
Business Combinations

Day 2 Accounting (Cont’d)

• Day 2: Nonperforming/Impaired loans
  ➢ Unaccretable yield
  ➢ Accretable yield
  ➢ Past due reporting (RC-N item 10)
  ➢ Nonaccrual reporting
  ➢ ALLL – timing of impairment recognition
Business Combinations

Day 2 Accounting (Cont’d)

- Day 2: Performing/Nonimpaired loans
  - Discount/premium accretion
  - ALLL – incurred losses after acquisition date
  - Past due reporting (RC-N item 10)
### Example of Combination

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Challenges
Business Combinations

Challenges

• Obtaining key data
  ➢ Access to acquiree’s loan system is critical
  ➢ Appraisals for loans, OREO, and premises
  ➢ Deposit and assumed debt obligations

• Creation of acquisition policy and procedures
  ➢ Initial decisions made will affect operations and accounting
  ➢ Permanent decision
Business Combinations

Challenges (Cont’d)

• Resources
  ➢ Internal vs. External
• Proper recognition of valuation to general ledger
  ➢ Loan system to general ledger
  ➢ Financial reporting
FDIC Assisted Transactions and Loss Sharing Agreements
Business Combinations

Failing Bank Acquisition – FDIC Loss Sharing Agreements

• Similar accounting rules followed for FDIC assisted business combinations

• Loss sharing agreement creates an indemnification from the FDIC recorded as a derivative or indemnification asset

➢ Derivative ASC 815 (SFAS 133) or an indemnification asset ASC 805 (SFAS 141(R))

▪ Either approach appropriate
▪ Covered assets and agreement are separate units of account
Business Combinations

Failing Bank Acquisition – FDIC Loss Sharing Agreements (Cont’d)

• Subsequent accounting differs for derivative and indemnification approaches

  ➢ Derivative accounted for at fair value with changes recognized in earnings
  ➢ Indemnification asset accounted for on the same basis as the indemnified asset subject to an assessment of collectability
Business Combinations
Failing Bank Acquisition – FDIC Loss Sharing Agreements (Cont’d)

• Monthly/Quarterly reporting and claims reporting
  ➢ Single-family loans
  ➢ Non single-family loans

• Audit requirements
  ➢ Internal audit
  ➢ External audit
  ➢ FDIC or third-party designee

• Record retention requirements
  ➢ Failed institution records
Business Combinations

Failing Bank Acquisition – FDIC Loss Sharing Agreements (Cont’d)

- Identified Weaknesses
  - Began hiring special assets staff 3 months after acquisition date
  - Set up general ledger six months after acquisition date
  - Used origination date as key field – did not realize date changes with restructuring
  - Combined covered assets and indemnification as one unit of account for reporting
  - Poor communication between accounting staff and valuation team
Regulatory Reporting and Guidance
Business Combinations

Regulatory Reporting and Guidance

• Appendix B of the Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Activities
  ➢ Delinquency status of purchased loans
    ▪ RC-N, item 10 – loans covered by loss-sharing agreement
    ▪ RC-N, Memorandum item 7, nonaccrual added during reporting period
  ➢ Goodwill and bargain purchase gains
  ➢ Risk-Weighted assets – 20 percent
  ➢ Additional disclosures
    ▪ Indemnification agreement – Schedule RC-F, Other Assets, item 6, “all other assets”
    ▪ Assets covered by FDIC loss share – RC-M, items 13.a through 13.d
    ▪ ASC 310-30/SOP 03-3 loans – RC-C, Memorandum item 7
    ▪ ASC 310-20/SFAS 91 loans – RC-C, Memorandum item 2
Business Combinations
Regulatory Reporting and Guidance (Cont’d)

• Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Activities

• FDIC supervisory insights article – Summer 2010
  ➢ Loss Sharing Primer

• Technical practice aid (TPA) 9110.16, *Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions*