Business Combinations – Bargain Purchase Gains

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Guidance Overview

- Issued on June 7, 2010 – Interagency (FRS's SR10-12)
- Developed in response to increased bargain purchases
- Highlights certain related accounting and reporting issues
- Provides supervisory considerations, including in the application approval process

Bargain Purchase

- ASC 805 (formerly FAS 141(R))
- Business combination where

Fair value of assets acquired and liabilities assumed (‘net assets acquired’)	>	Fair value of consideration transferred

- A bargain purchase is recorded as a gain (net of deferred taxes) in earnings in the period of acquisition
- Acquiring institution records provisional amounts for the FVs based on best information available at the acquisition date – subsequently adjusted during measurement period as new information is obtained (quality is critical)
- Increases capital (GAAP and regulatory)
- While originally thought to be rare situations, recent market conditions have contributed to an increase in bargain purchase gains

Fair Value

- All recognized assets acquired and liabilities assumed measured at their acquisition-date FVs, with limited exceptions
- FV measured in accordance with ASC 820

  (formerly FAS 157)
- ‘The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date’
- Exit price; not entry price
- Orderly transaction; not a distressed sale or forced transaction
- Market participants; not entity specific

Fair Value - Loans

- No ALLL carryover
- Credit impairment along with other factors considered in FV estimate
- FV measured in accordance with either:
  - ASC 310-30 (formerly SOP 03-3) for purchased impaired loans or
  - ASC 310-20 (formerly FAS 91) for purchased non-impaired loans:
    - Although SEC would not object to organization using purchased impaired approach provided policy election is disclosed and applied consistently; may not be used for loans specifically scoped out of ASC 310-30 (SEC December 18, 2009 letter)

Management Responsibility

- Accurate regulatory reports in accordance with GAAP, regulatory reporting requirements and relevant supervisory guidance
- Appropriate governance and effective internal control structure over regulatory report preparation, including policies and procedures related to business combinations
- Appropriate policies, procedures, and controls related to FV measurements; FV supporting documentation

Management Responsibility
(Cont'd)

- Engage third party experts if management does not possess the expertise to identify and measure the identifiable assets and the liabilities assumed:
  - Does not relieve management of responsibility to ensure FV estimates are in accordance with GAAP
- Retrospectively adjust provisional amounts to reflect recently obtained acquisition-date facts and circumstances promptly:
  - Despite measurement period, management must report at the earliest possible reporting date – no delay

FDIC-Assisted Acquisitions

- Distressed financial institutions are auctioned to a limited number of participants with an expedited due diligence process
- FDIC often enters into a loss-sharing agreement (LSA) with the acquirer that indemnifies the acquirer for certain losses covered under the agreement
- Applying ASC 805 acquisition method, recognize and measure identifiable assets acquired and liabilities assumed; may include an indemnification asset from the LSA
- Institution recognizes and measures either goodwill or a bargain purchase gain

Business Combination Applications

- Acquirer should submit appropriate application to its primary federal regulator and the state for prior approval
- If a business combination will result in a bargain purchase, application should include one pro forma balance sheet with two sets of pro forma capital calculations
  - Set 1 = pro forma capital calculations prepared based on applicable regulatory capital guidelines

Business Combination Applications (Cont'd)

- Set 2 = pro forma capital calculations eliminating from pro forma regulatory capital (1) any bargain purchase gain expected to be recognized in the proposed business combination and (2) any bargain purchase gains from prior business combinations for which the 'conditional period' has not yet ended
  - 'conditional period' – the timeframe during which supervisory conditions are in place – typically in place until the measurement period for accounting purposes ends and management's FV estimates and related bargain purchase gain have been validated through an independent external audit (or agree-upon procedures engagement) or examiner review

Possible Approval Conditions Imposed

- Capital Preservation – maintain specified levels of capital to address risk of significant retrospective adjustments to bargain purchase gain
- Dividend Limitations – exclude the bargain purchase gain from dividend-paying capacity calculation until the end of the conditional period
- Independent Audits or Agreed-Upon Procedures Engagements – if not subject to annual audit requirement, obtain and independent audit or engage an independent public accountant to perform agreed-upon procedures
- Independent Valuations – if internal expertise is lacking, obtain independent valuations; provide analyses on completed valuations until the end of the conditional period
- Legal Lending Limit – exclude bargain purchase gain from legal lending limit calculation until the end of the conditional period