This presentation is not a comprehensive analysis of the subject matters covered and may include proposed guidance that is subject to change before it is issued in final form. All relevant facts and circumstances, including the pertinent authoritative literature, need to be considered to arrive at conclusions that comply with matters addressed in this presentation. The views and interpretations expressed in the presentation are those of the presenters and the presentation is not intended to provide accounting or other advice or guidance with respect to the matters covered.
Business combinations and goodwill impairment

Objectives

• Understand overall accounting for business combinations
• Understand accounting for FDIC Loss Share
• Understand accounting for combinations of mutuals

Scope

Definition of a business combination

**Business combination:** A transaction or other event in which an acquirer obtains a controlling financial interest in a business

Consists of both (a) a more than insignificant variable interest and (b) the ability to control the most important activities of the entity. This is typically through a majority of common voting stock.

ASU 2017-01: inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs. Outputs are not required. Unless substantially all the assets concentrated in single asset
ASC 805, Business Combinations

Does the transaction or event meet the definition of a business combination?

N

Account for the transaction as an asset acquisition (or otherwise)

Y

Account for the transaction by applying the acquisition method

Asset acquisition versus business combination

Why does it matter?

<table>
<thead>
<tr>
<th>Asset acquisition</th>
<th>Business combination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognize assets acquired and liabilities assumed by allocating the cost on the</td>
<td>Accounted for using the acquisition method</td>
</tr>
<tr>
<td>basis of their relative fair values at the date of purchase</td>
<td></td>
</tr>
<tr>
<td>Does not give rise to goodwill</td>
<td>Gives rise to goodwill or a gain on bargain purchase</td>
</tr>
<tr>
<td>Capitalize acquirer's transaction costs</td>
<td>Expense acquirer's transaction costs</td>
</tr>
</tbody>
</table>
Definition of a business: ASU 2017-01

Single or Similar Asset Threshold
- Substantially all FV of gross identifiable assets acquired is concentrated in a single or group of similar assets

Threshold Met
- Not a business

No
- Further evaluate to determine whether the set includes an input and a substantive process

Any system, standard, protocol, convention or rule that, when applied to an input, creates or has the ability to create outputs

ASU 2017-01: Definition of a business
Evaluating a set not caught by the screen

To be considered a business, the set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create an output

Does the set have outputs?
- NO
- YES

Business if any of the following are present:
- Organized workforce or a contract that provides access to organized workforce
- Acquired process(es) that has a significant contribution to produce output and
  - Cannot be replaced without significant cost and effort or
  - Are unique or scarce

Business if it includes an organized workforce and an input that the workforce could develop/convert into output
Bank A purchases a loan portfolio from Bank Z. The portfolio of loans consists of residential mortgages with terms, size and risk ratings that are not significantly different. Bank A does not acquire the employees of Bank Z that managed the credit risk of the portfolio and the relationship with the borrowers.

Bank A concludes that the nature of the assets acquired is similar, and that the risks associated with managing and creating outputs are not significantly different. Accordingly, Bank A concludes substantially all of the fair value of the gross assets acquired is in a group of similar identifiable assets - the set is not a business as the single or similar asset threshold is met.

Acquisition of a Loan Portfolio
Example 6, Case H, Scenario 1

Assume the same facts as in Scenario 1 except that the acquired loan portfolio consists of commercial loans with term, size and risk ratings that are significantly different.

Bank A concludes that the nature of the commercial loans are similar, but the risks associated with managing the assets to create outputs is different – therefore the assets are not similar and the single or similar asset threshold is not met.

The loans have outputs (interest income), but because the acquisition does not include an organized workforce, it is not a business.
Acquisition of a Loan Portfolio
Example 6, Case H, Scenario 3

Assume the same facts as in Scenario 2 except Bank A takes over the employees of Bank Z that managed the credit risk and borrower relationships.

Bank A concludes that the assets do not meet the single or similar asset threshold.

Bank A further concludes that the set has outputs (interest income) and that the acquired employees represent an assembled workforce that performs processes critical to creating outputs – therefore the acquisition is a business.

ASU 2017-01: Definition of a business
Effective dates and transition

**Public business entities**
Annual periods, including interim periods within those annual periods, beginning after December 15, 2017

**All other entities**
Annual periods beginning after December 15, 2018 and interim periods within annual periods beginning after December 15, 2019

**Transition**
Prospective

**Early application**
Permitted for transactions that have not been reported in financial statements issued or made available for issuance
Business combinations – the acquisition method

1: Identify the acquirer

2: Determine the acquisition date

3: Recognize and measure consideration transferred

4: Recognize and measure identifiable assets acquired and liabilities assumed, and any noncontrolling interest in the acquiree

5: Recognize and measure goodwill or gain from bargain purchase

Identify the acquirer

Generally, the party that directly or indirectly holds > 50% of the voting shares has control

When a legal entity (not a group of assets) is acquired, evaluate who obtained "controlling financial interest" (per ASC 810-10)

If unclear in ASC 810-10 - use the guidance/factors in ASC 805-10-55-11 through 55-15
Identify the acquirer
When not immediately clear…

<table>
<thead>
<tr>
<th>Factor to consider</th>
<th>Who is <em>usually</em> the acquirer?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relative voting rights in the combined entity</td>
<td>The entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity</td>
</tr>
<tr>
<td>Composition of the governing body of the combined entity</td>
<td>The entity whose former management dominates the management of the combined entity</td>
</tr>
<tr>
<td>Relative size</td>
<td>The entity whose size is significantly greater than that of the other combining entity or entities</td>
</tr>
<tr>
<td>A new entity is formed to effect a new business combination</td>
<td>If the entity is formed to issue equity instruments, one of the existing combining entities is the acquirer where if the new entity transfers cash (or other assets or incurs liabilities) the new entity may be the acquirer</td>
</tr>
</tbody>
</table>

Acquisition method

1: Identify the acquirer
2: Determine the acquisition date
3: Recognize and measure consideration transferred
4: Recognize and measure identifiable assets acquired and liabilities assumed, and any noncontrolling interest in the acquiree
5: Recognize and measure goodwill or gain from bargain purchase
Determine the acquisition date

**Acquisition date**: the date on which the acquirer obtains control of the acquiree.

- Acquirer legally transfers consideration, acquires assets and assumes liabilities.

**Acquisition method**

1. Identify the acquirer
2. Determine the acquisition date
3. Recognize and measure consideration transferred
4. Recognize and measure identifiable assets acquired and liabilities assumed, and any noncontrolling interest in the acquiree
5. Recognize and measure goodwill or gain from bargain purchase
Recognize and measure consideration transferred

- Acquisition date fair value of assets transferred to sellers
- Acquisition date fair value of liabilities incurred to sellers
- Acquisition date fair value of equity interests issued to sellers
- Contingent consideration

Exclude:
- Transaction costs
- Amounts/arrangements that are not part of the business combination

Contingent consideration:
Usually an obligation of the acquirer to transfer additional assets or equity interest to the acquiree’s former owners if specified future events occur or conditions are met.

- Recognised and measured at fair value on the acquisition date, after consideration of likelihood of payment
- Directly impacts goodwill and reported liabilities or equity
- Determine classification as financial asset, liability or equity (ASC 480)
- Asset or liability subsequently remeasured through P&L until settled
- Equity not remeasured
Recognize and measure consideration transferred

Amounts that are not part of the business combination

Amounts transferred in transactions that are NOT part of the business combination, include:

- Effective settlement of preexisting relationships between acquirer and acquiree
- Compensation to employees or former employees for future services, even if some were sellers
- Restructuring costs

Step acquisition

Occur when control of a business is obtained after the acquirer already owns a non-controlling (minority) interest in the acquiree’s equity

Acquirer may pay a premium over market to obtain control of the acquired entity (commonly referred to as a control premium)

Noncontrolling interest will be reported as a separate component of consolidated equity (separate from the parent shareholders’ equity)

Net income or loss presented for the consolidated reporting entity and attributed to controlling and noncontrolling interests

Losses attributable to noncontrolling interests could reduce the carrying values of those interests below zero
Acquisition method

1: Identify the acquirer
2: Determine the acquisition date
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4: Recognize and measure identifiable assets acquired and liabilities assumed, and any noncontrolling interest in the acquiree
5: Recognize and measure goodwill or gain from bargain purchase

Recognize and measure identifiable assets acquired and liabilities assumed

General Principles

Recognition
- Only if:
  - Meet the definition of an asset or liability in Concepts Statement 6
  - Are part of the business combination transaction

Measurement
- Acquisition date fair value

Classification
- Based on contract terms, economic conditions and acquirer's policies and other relevant factors
Recognize and measure identifiable assets acquired and liabilities assumed

**Measurement period considerations**

Period ends the earlier of (a) when have necessary information or (b) one year. If open, each reporting period disclose information still obtaining.

**Measurement period adjustments**
- Limited to those that arise from new information obtained about facts and circumstances that existed at the acquisition date

**Accounting:**
- Recognise adjustments to the provisional amounts and/or recognise new assets/liabilities to reflect the new information in the reporting period in which the adjustment amount is determined
- Adjust goodwill

**Other adjustments during measurement period**
- Include adjustments for developments after the acquisition date but during the measurement period (eg changes in estimates)

**Accounting:**
- Prospectively adjust provisional amounts to reflect new information arising after the acquisition date
- No adjustment to goodwill
- Correct errors retrospectively

**Post-measurement period adjustments**

**Accounting:**
- No adjustment to the accounting for the business combination allowed except for the correction of an error

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Recognize and measure identifiable assets acquired and liabilities assumed

**Intangible assets**

ASC 805-20-25-10: Recognize separately from goodwill the identifiable intangible assets acquired in a business combination

**Is the asset identifiable?**

- Does the asset meet the contractual-legal criterion
- Does the asset meet the separability criterion

- Yes

**Recognise, separately from goodwill, the identifiable intangible assets acquired**

**Common in Bank Acquisitions:**
- Servicing Rights
- Core Deposit Intangibles
- Trade Names
ASU 2014-18, Accounting for Identifiable Intangible Assets in a Business Combination

Overall guidance

• Allows private companies in a business combination to elect not to separately recognize and measure:
  – Noncompetition agreements and
  – Customer-related intangible assets that cannot be sold or licensed independently

• Must also adopt ASU 2014-02, *Accounting for Goodwill*

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Acquisition method

1: Identify the acquirer

2: Determine the acquisition date

3: Recognize and measure consideration transferred

4: Recognize and measure identifiable assets acquired and liabilities assumed, and any noncontrolling interest in the acquiree

5: Recognize and measure goodwill or gain from bargain purchase
3-5 overview

- Consideration transferred
- FV of NCI
- FV of previously held interests in acquiree (bus com achieved in stages)
- FV of assets acquired
- FV of liabilities assumed

= Goodwill / Bargain purchase gain

Question:
When an entity calculates a gain resulting from a bargain purchase, what should the entity do?

Answer:
• Reassess whether it has identified all of the assets acquired and all of the liabilities assumed
• Recognize any additional assets or liabilities identified
• Review procedures used to measure the amounts for:
  – Consideration transferred
  – NCI in the acquiree
  – Previously held equity interest in the acquiree

May occur with FDIC assistance
Pushdown accounting
Requirements

Entities applying pushdown accounting must reflect the acquirer's basis in the target:

• Measure individual assets/liabilities of the acquired entity based on guidance in ASC 805, Business Combinations

• Do not pushdown acquirer's bargain purchase gain to the acquiree's income statement
  – Recognized as an adjustment to APIC

• Disclose sufficient information to enable readers to understand the effects of pushdown accounting, if applied
  – Disclosures under ASC 805 required

FDIC Indemnification Assets – ongoing accounting

<table>
<thead>
<tr>
<th>Event</th>
<th>Indemnified Loans (310-30)</th>
<th>Indemnification Asset (805-20-35-4B)</th>
<th>Claw-Back Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in cash flows on indemnified loans</td>
<td>Prospectively increase yield</td>
<td>Prospectively increase accretion</td>
<td>Evaluate under FAS 5, considering the time value of money</td>
</tr>
<tr>
<td>Decrease in cash flows on indemnified loans</td>
<td>Reverse previous allowance</td>
<td>Immediate write-down</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Immediate impairment</td>
<td>Immediate write-up</td>
<td></td>
</tr>
</tbody>
</table>
FDIC Indemnification Assets – extinguishment accounting

Derecognize at their carrying amount
- Indemnification Asset
- Claw-Back Liability

Determine fair value of consideration paid / received
- Typically cash paid to FDIC, b/c as the LSA winds down, often the claw-back will exceed the IA

Net: Gain / Loss (Other Income)
- If the gain/loss is significant, it may call into question whether the bank’s historical accounting has an error

CU’s – Combinations of Mutuals by exchange of member interests

Identify the acquirer (805-10-55-11 through 55-15) – difficult

Consideration – determine FV of either (whichever is more readily determinable): (a) Target CU’s member interests – OR – (b) Fair value of target CU as a whole

Add FV of consideration to acquirer’s member’s surplus account

Determine fair value of identifiable assets acquired and liabilities assumed

Goodwill recognized to extent target CU’s FV as a whole exceeds FV of target’s net assets (member’s interests)
CU’s – Combinations of Mutuals by exchange of member interests

Example:
• Two mutual merge by exchanging membership interests
• FV of acquiree as a whole: $150

<table>
<thead>
<tr>
<th></th>
<th>Target CU</th>
<th>Acquirer CU</th>
<th>Combined CU</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Book Value</td>
<td>Fair Value</td>
<td>Book Value</td>
</tr>
<tr>
<td>Traditional Assets</td>
<td>500</td>
<td>500</td>
<td>1,000</td>
</tr>
<tr>
<td>Identifiable Intangibles</td>
<td>-</td>
<td>10</td>
<td>-</td>
</tr>
<tr>
<td>Goodwill</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total Assets</td>
<td>500</td>
<td>560</td>
<td>1,000</td>
</tr>
<tr>
<td>Borrowings</td>
<td>400</td>
<td>440</td>
<td>800</td>
</tr>
<tr>
<td>Member’s Surplus</td>
<td>40</td>
<td>50</td>
<td>-</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>60</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td>Total Equity</td>
<td>100</td>
<td></td>
<td>200</td>
</tr>
</tbody>
</table>

FV of Assets Acquired: $500
FV of Liabilities Assumed: $440
FV of Net Assets: $120
FV of Target CU as a Whole: $150
Goodwill: $30