Agenda

- Review of accounting for business combinations
- Updates on new standards and proposed changes
- In-depth review of certain challenging areas
- Lessons learned and best practices
- Disclosures
What is a Business Combination?

• **Business combination vs. asset acquisition**
  – Definition of a business – ASC Section 805-10-55 (and soon, ASU 2017-01)
  – Examples
    • Whole bank
    • Branches
    • Division or business unit (loan portfolio with operations)

• **Identification of the acquirer**
  – “Controlling financial interest” – ASC Subtopic 810-10
  – Additional factors – ASC Section 805-10-55
  – Accounting vs. legal acquirer

• **Acquisition and measurement date**
  – The date control is obtained
Definition of a Business

- Current definition is broadly interpreted
- Important distinction, due to significant differences in accounting for assets versus businesses

<table>
<thead>
<tr>
<th>Current definition</th>
<th>ASU 2017-01</th>
</tr>
</thead>
<tbody>
<tr>
<td>Requires inputs and processes</td>
<td>Requires inputs and one or more substantive processes</td>
</tr>
<tr>
<td>Outputs defined broadly as ability to provide a return</td>
<td>Narrows definition to focus on revenue to align with ASC 606</td>
</tr>
<tr>
<td>Does not matter if all value is attributable to a single asset</td>
<td>Requires evaluation of threshold (e.g., if substantially all of the value transferred relates to a single asset, it is an asset acquisition)</td>
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</table>
Apply the Acquisition Method

- Determine Purchase Consideration
- Identify Separate Transactions
- Recognize Net Assets at Fair Value

Goodwill/Bargain Purchase Gain
Applying the Acquisition Method

• Purchase consideration
  – Fair value of consideration transferred
    • Cash
    • Equity issuance
    • Contingent consideration
    • Other assets or instruments transferred
  – Consider…
    • Escrows
    • Working capital true up
Purchase Consideration

• Noncontrolling interest
  – Recognize and initially measure at fair value

• Equity Awards
  – If the acquirer is obligated to replace the acquiree awards, either all or a portion of the fair-value-based measure of the acquirer’s replacement awards shall be included in measuring the consideration transferred in the business combination.
    • Includes obligations arising from the terms of the acquisition agreement, terms of the acquiree’s awards, or applicable laws or regulations.
      - ASC 805-30-30-9
  – What does this look like?
Purchase Consideration

• Example (simplified):

  Replacement options to be issued:
  Vested prior to the acquisition date(a)  8,000

  Unvested awards requiring add'l service  2,000
  ______________________________________
  Total 10,000

  Option Value (ASC 718)
  Acquiree award $ 1.50
  Replacement award $ 2.00

  Purchase consideration attributed to replacement stock awards
  ($1.50 x 8,000)  $ 12,000

  Post-combination compensation expense ($20,000 - $12,000)  $ 8,000

(a) Assumes no post-combination service required

• Purchase consideration may ≠ announced deal price!
Applying the Acquisition Method

• Identify assets acquired and liabilities assumed
  – Assets acquired and liabilities assumed are generally measured at fair value

• Certain exceptions (ASC Section 805-20-30)
  a. Income taxes
  b. Employee benefits
  c. Indemnification assets
  d. Reacquired rights
  e. Share-based payment awards
  f. Assets held for sale
  g. Certain assets and liabilities arising from contingencies
Goodwill/Bargain Purchase Gain

Purchase consideration & NCI
Less: Fair value of net assets acquired
Equals: Goodwill/(bargain purchase gain)

- Bargain purchase gains are rare... should be a reason
  - GAAP requires a reconsideration of acquisition method fair values
Measurement Period Adjustments

- Changes to provisional amounts based on new information about facts that existed at acquisition date

<table>
<thead>
<tr>
<th>Old GAAP</th>
<th>New Standard</th>
</tr>
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<tbody>
<tr>
<td>Retrospectively adjust all comparative prior periods</td>
<td>Recognize in period adjustment is identified</td>
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</tbody>
</table>

- Present or disclose amounts related to prior periods by line item (e.g., amortization)
- No changes to measurement period criteria or length of time

<table>
<thead>
<tr>
<th>Effective dates for calendar year ends</th>
<th>Transition method</th>
<th>PBE</th>
<th>Non-PBE</th>
<th>Early application?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Prospective</td>
<td>2016</td>
<td>2017</td>
<td>Yes</td>
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</table>
Other Elements of a Transaction

• What is part of the business combination and what is a separate transaction?
  – Principle to apply: Does the transaction benefit the acquirer or post-combination entity? (ASC Section 805-10-25)
  • More on this later

• Transaction costs
  – Expense as incurred
  – Debt and equity issuance costs may be capitalized if permitted under other areas of GAAP
Don’t Forget...

- **Contingent consideration**
  - Initially measured at fair value
  - Determine equity or liability classification
    - Liability awards are marked to market each period
  - “Point in time” analysis
- **Taxes**
  - NOL carryforwards
  - Executive compensation
- **Pushdown accounting**
Pushdown Accounting

• What is it?

• Accounting standard issued Fall 2014
  – Superseded longstanding SEC guidance

• Optional application at the “change of control” threshold

• Banking regulators
  – Generally have accepted the new standard
  – “Reserve the right” to require or prohibit…
  – Call report supplemental instructions
Lessons Learned

• Branches acquired in an acquisition
  – Assumptions about valuation can be dangerous
  – Issues noted in practice
    • Appraisals vs BPOs vs analytical analysis

• Passed adjustments and application of materiality

• Controls (more to come on this)

• Defining merger-related expense

• Internal control over financial reporting
Areas of Challenge

- Compensation arrangements
- Recognition and measurement of assets acquired and liabilities assumed
- Identifying transactions separate from the business combination
- Loan accounting
- Banks as Public Business Entities
Compensation Arrangements

- Compensation arrangements – Does the acquirer or the target benefit from the arrangement?

- Contingent consideration payments to employees and shareholders
  - ASC 805 includes indicators that should be considered in accounted for as consideration or compensation

- Share-based payments (ASC 805-30-30)
  - Generally treated as replacement awards (similar to modification accounting)
  - Detailed rules on what is purchase consideration, an assumed liability and a post-combination expense
Compensation Arrangements

• Retention or severance payments
  – What’s the context of the arrangement?
  – Which entity initiated and is benefiting from the transaction?

• Examples
  – Executive severance payment as part of a pre-existing employment agreement
  – Staff/employee severance payment to continue through the acquisition date

• Double-trigger arrangements
Compensation Arrangements – Example 1

- Target hired a chief executive officer (CEO) pursuant to a five-year employment contract
- Target will pay $1 million to the CEO in the event Target is acquired by another company and the CEO remains employed through the acquisition date
- Acquirer acquires Target two years after the employment contract is signed
- The CEO was employed at the acquisition date and will receive the $1 million payment under the existing contract
- What is accounting pre and/or post combination?
Compensation Arrangements – Example 2

- Assume same facts as included in Example 1, except that the employment contract with the CEO was executed at the suggestion of Acquirer during the negotiations for the business combination.

- What is accounting pre and/or post combination?

- If it was determined that the arrangement was to provide severance pay to the CEO, the Acquirer would record the payment as compensation expense in the post-acquisition financial statements of the combined company.
Compensation Arrangements – Example 3

• Target hired an executive pursuant to a five-year employment contracts

• Target is required to pay $100,000 to the executive in the event that (1) Target is acquired and (2) the executive’s employment is terminated or his responsibilities or salary are reduced significantly (as defined in the employment agreement) subsequent to the acquisition

• Acquirer acquires Target two years after the employment contract was signed with Target and on the acquisition date, enters into a new employment contract with the executive which significantly reduces the executive’s salary. As a result, the executive will receive the $100,000 payment.

• What is accounting pre and/or post combination?
Compensation Arrangements – Example 4

• Acquirer agrees to provide each of the key officers of Target with a cash payment of $200,000 if they remain with the combined company for a period of one year following the acquisition date.

• If the officers resign prior to the anniversary of the acquisition date, they forfeit their rights to the payments.

• A similar arrangement was not included in the officers’ employment agreements prior to the acquisition.

• What is accounting pre and/or post combination?
Recognition and Measurement

• Identifiable intangible assets
  – Contractual-legal criterion
  – Separability criterion

• Example intangible assets to recognize
  – Core deposit
  – Trade name
  – Leases (or other contracts) with favorable or unfavorable terms compared to current market transactions
  – Bank charter/license
  – Lease contracts at market terms
  – Other contractual relationships that have value
    • For example, trust services or asset management contracts
Recognition and Measurement

• Unused and defensive intangible assets

  – A defensive intangible asset could include any of the following:
    • An asset that the entity will never actively use
    • An asset that will be used by the entity during a transition period when the intention of the entity is to
discontinue the use of that asset

  – EITF Issue 08-7, to resolve practice issues associated with FAS 141(R) and FAS 157
    • “Historically, when an entity acquired a business or group of assets, it typically allocated little or no value to the
intangible assets that it did not intend to actively use, regardless of whether another acquirer might have
continued to actively use them. However, after the effective date of Statement 141(R), an intangible asset must
be recognized at fair value in accordance with Statement 157, regardless of how the entity intends to use that
asset.”
    • ASC Codification Subtopic 350-30
Using Estimates in Financial Statements

- **Ultimate responsibility – management**
  - Level of diligence/rigor reviewing a specialist's assumption and judgments
  - Audit regulators are clarifying expectations for auditors
    - Specified procedures
    - Controls
Recognition and Measurement

• Contingencies
  – ASC Sections 805-20-25 and 805-20-30
  – Recognize if:
    • Acquisition date fair value can be determined during the measurement period
    • Probable that an asset or liability existed at acquisition date, and the amount can be reasonably estimated
  – Initial measurement at fair value
  – Consider information available in the purchase agreement; complete listing of potential contingencies is generally disclosed
Recognition and Measurement

• Indemnification asset

• May arise from indemnification of assets (e.g. loan or OREO value) or liabilities (e.g. lawsuits or contingencies)

• Recognize asset at the same time the indemnified item is recognized and on the same basis
  – Consider need for valuation allowance

• Subsequently measure on the same basis as the indemnified item (ASC Section 805-20-35)
  – Additional guidance for FDIC indemnification assets
Transactions Separate from the Business Combination

• What is part of the business combination and what is a separate transaction?
  
  – Principle to apply: Does the transaction benefit the acquirer or post-combination entity? (ASC Section 805-10-25)
  
  – Examples
    • Integration (or other) costs paid by the acquiree
    • Debt refinancing/retirements
    • Pre-existing contracts or other relationships
    • Compensation of employees or former owners for future service
Transactions Separate from the Business Combination

• Practical examples
  – Contract termination costs
  – Double-trigger compensation agreements
  – Branch optimization / disposition
Categories of Acquired Loans

- Purchased loans fall into one of the following categories:

- Category 1: Impaired loans
  - ASC 310-30 (formerly SOP 03-3)

- Category 2: All other loans
  - ASC 310-20 (formerly FAS 91)

- Category 3 (optional): Loans purchased with a discount due (at least in part) to credit quality
  - Policy election by acquiring institution to apply ASC 310-30 by analogy
  - Once elected, loans in this category follow all aspects of ASC 310-30

- Analysis must be done at the individual loan level!
ASC 310-30 vs. 310-20

- ASC 310-30 uses the acquirer’s “cash flows expected at acquisition” as the basis for calculating the loan yield and for determining subsequent impairment. This model results in a level yield over the expected life of the loan.

- ASC 310-20 uses contractual cash flows to determine yield and subsequent impairment. Entire discount (or premium) is accreted (amortized) to par, generally over the remaining contractual term of the loan.
ASC 310-30 Scope

• Evaluate purchased (or acquired) loans on a loan-by-loan basis

• Loans that meet the following criteria must be accounted for under ASC 310-30:
  – Evidence of deterioration in credit quality subsequent to origination, and
  – Probable that the acquirer will be unable to collect all contractually-required payments from the borrower

• Loans with revolving privileges are specifically scoped out
ASC 310-30 Income Recognition

- Under ASC 310-30, the expected cash flows that exceed the initial investment in the loan represent the “accretable yield”
  - Recognized as interest income on a level-yield basis over the life of the loan
  - Calculated by considering the amount and timing of future cash flows from all sources
- The difference between the cash flows expected at acquisition and the total contractual cash flows is considered the “non-accretable difference”
ASC 310-30

• Loan pools
  – Acquirer may aggregate loans acquired together that have common risk characteristics, which requires that the loans have both:
    • Similar credit risk or risk ratings, and
    • One or more other predominant risk characteristics

• Acquirer should continue to estimate cash flows expected to be collected over the life of the loan
  – Increased in expected cash flows – the yield on the loan pool should be prospectively revised upward based on the new estimate of cash flows exceeding the investment in the loan
  – Decrease in expected cash flows – recognize impairment through a provision for loan losses sufficient to reduce the carrying amount and maintain the same yield determined at acquisition
Disclosures

• Disclosure requirements are spread across three Subtopics of the Codification:
  – 805-10-50
  – 805-20-50
  – 805-30-50

• Requirements include:
  – Pro-forma information (public business entities only)
  – Reconciliation of purchase consideration, fair value of net assets acquired, and goodwill/bargain purchase gain recognized
  – Transaction details
    • Reason for the transaction
    • Transaction expenses
    • Other transactions entered into in close proximity
  – SEC comments
Internal Controls

• Documenting process to obtain an understanding of the likely sources of potential misstatements, including points in the process at which a control is missing or not designed effectively (What could go wrong - WCGW?)

• Designing controls, including -
  – Precision of review controls
  – Authority and competence of reviewer

• Evaluating controls over system-generated data or reports (information produced by the entity or IPE)

• Assessing/testing operating effectiveness of controls

• Remediating deficiencies

• Evaluating deficiencies
## Internal Controls

- **What could go wrong (WCGWs)? Examples:**

<table>
<thead>
<tr>
<th>What could go wrong?</th>
<th>What could go wrong?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquisition is not approved and authorized</td>
<td>Acquired assets are not properly valued at acquisition date</td>
</tr>
<tr>
<td>All intangible assets are not identified</td>
<td>Data inputs and assumptions used in the valuation are inaccurate</td>
</tr>
<tr>
<td>Assets and liabilities recorded in the acquisition do not exist</td>
<td>Footnote disclosures do not meet GAAP requirements</td>
</tr>
<tr>
<td>Journal entries are not recorded properly</td>
<td>Acquisition payment is not properly authorized or paid timely</td>
</tr>
<tr>
<td>Accounting is not in accordance with GAAP</td>
<td>Information produced by the entity is incomplete or inaccurate</td>
</tr>
</tbody>
</table>
Segments – Terminology

- **Reportable Segment 1**
  - Operating Segment 1
  - Reporting Unit 1
  - Reporting Unit 2

- **Reportable Segment 2**
  - Operating Segment 2

- **Reportable Segment 3**
  - Operating Segment 3
Identifying the Operating Segment – Definition of Operating Segment

• Engages in business activities

• Discrete financial information available
  – Full cost allocation not required

• CODM:
  – Regularly reviews
  – Operating results
  – Allocate resources and assess performance
    • More than “receives” and “uses”
  – Consider management structure, CODM report, budgets, compensation & other factors
Recent SEC Comments

- Measurement period adjustments
- Non-GAAP measure: Credit discount on acquired loans + ALLL/Total Loans
- Reporting unit allocation
Other Areas to Think About

• Loan accounting on Day 2
  – Loan accounting will change with CECL

• Integration

• SEC Reporting
  – Form 8-K report and Article 11 pro-forma financial information
  – Rule 3-05 financial statements
Questions?

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