Accounting News: Accounting for Business Combinations

This regular feature focuses on topics of critical importance to bank accounting. Comments on this column and suggestions for future columns can be e-mailed to ***SupervisoryJournal@fdic.gov.***

In an effort to improve the accounting for and reporting of mergers and acquisitions, the Financial Accounting Standards Board (FASB) issued a revised standard on the accounting for business combinations in December 2007 that will take effect in 2009. Under the standard's new guidance, key changes have been made to the accounting for business combinations that will require banks to modify their approach to the evaluation of and accounting for mergers and acquisitions. In reviewing applications for mergers and acquisitions that will be consummated after 2008 and post-acquisition bank financial statements, case managers will need to consider the changes the revised standard makes to the scope, terminology, and application of business combination accounting.

Background

Statement of Financial Accounting Standards No. 141 (revised), *Business Combinations* (FAS 141(R)), will replace Statement of Financial Accounting Standards No. 141, *Business Combinations* (FAS 141), and nullify Statement of Financial Accounting Standards No. 147, *Acquisitions of Certain Financial Institutions* (FAS 147), when it becomes effective for business combinations that occur in fiscal years beginning on or after December 15, 2008. The issuance of FAS 141(R) completes the second phase of the FASB's project to revise the accounting for business combinations. Until the first phase ended with the issuance of FAS 141 and Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (FAS 142), in June 2001, business combination accounting was guided by Accounting Principles Board No. 16, *Business Combinations* (APB 16).

Under APB 16, the pooling-of-interests method was used to account for business combinations if 12 conditions were met.[1] Otherwise, the "purchase method" of accounting (renamed the "acquisition method" under FAS 141(R)) was used. This practice changed with the issuance of FAS 141. Under FAS 141, all business combinations, except for combinations between two or more mutual entities (e.g., credit unions and mutual banks), were required to use the acquisition method to account for business combinations.

The culmination of the second phase of the FASB's project to update business combination accounting under FAS 141(R) will significantly affect the way banks and mutual entities account for business combinations occurring after this new standard takes effect. Among the institutions most affected by the changes made to business combination accounting rules are mutual entities, which no longer will be permitted to account for mergers between two or more such entities under the pooling-of-interests method. Thus, the pooling-of-interests method of accounting for business combinations between banks is now fully prohibited. FAS 141(R) also more broadly defines the term "business." As a result, more acquisitions will be treated as business combinations under FAS 141(R) than under FAS 141.

Foremost among the changes to the accounting for business combinations under the acquisition method in FAS 141(R) is the requirement to measure all identifiable assets acquired, all liabilities assumed, and any noncontrolling interests in the acquiree, with limited exceptions, at fair value as of the acquisition date. This change from the cost

[1] The conditions address the attributes of the combining companies, the manner in which the companies' interests are combined, and the absence of planned transactions after the combination.

allocation method applied under FAS 141 prohibits the "carrying over" of the target institution's allowance for loan and lease losses. These and other changes to the accounting for business combinations brought about by FAS 141(R) are summarized below.

At the same time that FAS 141(R) was issued, the FASB also issued Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (FAS 160). FAS 160, which amends Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB 51), also becomes effective for fiscal years beginning on or after December 15, 2008. A noncontrolling interest (previously referred to as a "minority interest") is defined as the portion of the equity in a subsidiary that is held by owners other than the parent company.[2] In a business combination resulting in the acquisition of less than a 100 percent ownership interest in a target entity, the application of FAS 141(R) and FAS 160 will change the way the noncontrolling interest in the target entity is measured at the acquisition date and where this interest is reflected on the balance sheet going forward.

Steps in Accounting for a Business Combination under FAS 141(R)

1. Determine whether the transaction is a business combination, as defined in FAS 141(R), which requires that the assets acquired and liabilities assumed constitute a business.
2. If the transaction is a business combination, account for the combination by applying the acquisition method. (If the transaction is not a business combination, account for it as an asset acquisition.)
3. Identify which of the combining entities is the acquirer.
4. Identify the acquisition date, which is the date the acquirer obtains control of the acquiree.
5. Recognize as of the acquisition date the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree subject to the conditions specified in FAS 141(R).
6. Classify or designate as of the acquisition date the identifiable assets acquired and liabilities assumed as necessary to apply other generally accepted accounting principles subsequent to the acquisition date.
7. Measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values, except as specified in FAS 141(R).
8. Recognize and measure goodwill or a gain from a bargain purchase by comparing (a) the consideration transferred, generally measured at its acquisition-date fair value, plus the fair value of any noncontrolling interest in the acquiree to (b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, measured in accordance with FAS 141(R). If (a) exceeds (b), recognize goodwill as of the acquisition date. If (b) exceeds (a), reassess and review the accounting for the transaction and then recognize any resulting gain in earnings on the acquisition date.

Key Change in the Approach Taken to Measure the Fair Value of the Target Entity as of the "Acquisition Date"

Under FAS 141(R), all identifiable assets acquired, all liabilities assumed, and any noncontrolling interest in the acquiree generally must be measured at *fair value* as of the acquisition date.[3] This measurement framework under FAS 141(R) contrasts sharply with the measurement framework used in current practice under FAS 141. Under FAS 141, the acquirer allocates the cost of the target institution to the identifiable assets acquired and liabilities assumed based in most cases on their *estimated fair values* at the date of the acquisition. Further, under FAS 141, certain assets and liabilities were not recognized (i.e., reflected on the balance sheet) at acquisition and others, such as loans (as discussed in the next section), were recorded at amounts other than fair value.

[2] See paragraph 25 of Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB 51), as amended.

[3] Fair value is defined by Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157), as "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." The acquisition date is defined in FAS 141(R) as "the date on which the acquirer obtains control of the acquiree."

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Also, "for convenience," FAS 141 allowed the acquirer to designate an effective date at the end of an accounting period between the initiation date and the consummation date of the business combination as the date as of which to estimate the fair value of the assets acquired and liabilities assumed. FAS 141(R) requires that the acquirer measure the fair value of the assets acquired, liabilities assumed, and any noncontrolling interest in the target institution at the acquisition date. As a result, "convenience date" accounting is eliminated.

FAS 141(R) provides exceptions to its recognition and fair value measurement principles for certain assets acquired and liabilities assumed, which should be accounted for under other applicable generally accepted accounting principles (GAAP). These include deferred tax assets and liabilities that are related to the assets acquired and liabilities assumed in the business combination. These deferred tax items should be accounted for under Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* (FAS 109). Similarly, potential tax effects created by any carryforwards and any tax uncertainties of an acquiree that exist as of the acquisition date or that result from the business combination should be accounted for under FAS 109 and related standards, such as FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*.

Moreover, the acquirer should account for any employee benefit arrangements assumed from the target institution based on other GAAP as it applies to each type of arrangement assumed. For example, certain postretirement benefits assumed in a business combination should be accounted for under Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FAS 106). Another exception to the fair value measurement principle under FAS 141(R) is for acquired assets that are held for sale. The acquirer must measure assets held for sale at their *fair value less cost to sell* in accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144). For banks, assets held for sale include other real estate acquired in foreclosure. Other exceptions to the fair value measurement principle under FAS 141(R) include share-based payment awards, reacquired rights, and indemnification assets.

Finally, in a business combination where the acquirer obtains less than a 100 percent ownership interest in the acquiree, which becomes a subsidiary in which there is a noncontrolling interest, the contrast between the measurement of the identifiable assets acquired and liabilities assumed under FAS 141 and FAS 141(R) is particularly striking. Under the new standard, the acquiree's assets and liabilities are recorded at their full fair value, regardless of the percentage of ownership the acquiring company obtains. FAS 141 takes a different approach by requiring the acquiring company to record the identifiable assets acquired and liabilities assumed in the business combination at blended amounts that combine the acquiring company's percentage share of the estimated fair values of these assets and liabilities and the noncontrolling (minority) interest's percentage share of the carrying amounts (book value) of these items on the acquiree's books. An additional consequence of the full fair value approach to measurement under FAS 141(R) is that the amount of goodwill to be recorded in a less than 100 percent acquisition will be larger than it has been under FAS 141, because this previous standard did not recognize "the portion of goodwill related to the noncontrolling interests in subsidiaries that are not wholly owned."[4]

[4] FAS 141(R), paragraph B329.

Accounting for Loans Acquired in a Business Combination under FAS 141(R)

A key change to the accounting for business combinations under FAS 141(R) is the prohibition on the "carrying over" of the target institution's allowance for loan and lease losses. In general, under current practice, the acquiring bank normally records the acquired held-for-investment loan portfolio at the present value of amounts to be received on the loans determined at an appropriate current interest rate less the target institution's allowance for loan and lease losses. This practice of "carrying over" the allowance for loan and lease losses was sanctioned by the staff of the U.S. Securities and Exchange Commission (SEC) in Staff Accounting Bulletin No. 61, which was issued in 1986, and has been accepted by the banking agencies for Call Report purposes.[5]

In contrast, the FASB has now determined that the practice of "carrying over" valuation allowances, such as the allowance for loan and lease losses, is not consistent with the fair value measurement principle in FAS 141(R). In the FASB's view, the uncertainties relating to the expected future cash flows should be reflected in the fair value measurement of the acquired loans, and therefore, they are already reflected in the purchase price of the acquired business. The accounting framework for loans in FAS 141(R) is consistent with the approach taken by the American Institute of Certified Public Accountants for "purchased impaired loans"[6] in Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3), which became effective in 2005.

The following example shows how the acquired held-for-investment loan portfolio is combined with the acquiring bank's held-for-investment loan portfolio as of the "acquisition date" in accordance with FAS 141(R).[7]

Loan Portfolio of Combined Banks at Acquisition Date

	Target Bank*		Acquiring Bank Carrying Amount	Acquisition Date Combined Banks
	Carrying Amount	Fair Value		
Held-for-Investment Loans	$5,000	$4,920**	$5,000	$9,920
Allowance for Loan and Lease Losses (ALLL)	50		50	50
Held-for-Investment Loans, net	4,950		4,950	9,870
ALLL/Loans	1.00%		1.00%	0.51%

* If Target Bank remains in existence as a separate legal entity after its acquisition and push down accounting is required, Target Bank will report no ALLL on its balance sheet at the acquisition date.

** Fair value of portfolio reflects an $80 discount from its recorded investment.

Accounting for Held-for-Investment Loans Acquired in a Business Combination Subsequent to the "Acquisition Date"

After an acquisition, the held-for-investment loans acquired from the target entity are accounted for like other purchased loans. Thus, the premiums and discounts on the loans that are not "purchased impaired loans" at acquisition will be amortized and accreted, respectively, over the life of the loans as an adjustment of yield in accordance with Statement of Financial Accounting

[5] SEC Staff Accounting Bulletin No. 61, *Adjustments to Allowances for Loan Losses in Connection with Business Combinations*, which has been codified as Topic 2.A.5. in the SEC's Codification of Staff Accounting Bulletins, www.sec.gov/interps/account/sabcodet2.htm#2a5.

[6] Purchased impaired loans are loans that a bank has purchased where there is evidence of deterioration of credit quality since the origination of the loan, and it is probable, at the purchase date, that the bank will be unable to collect all contractually required payments receivable.

[7] This example assumes that the acquiring bank designates all loans in this acquired portfolio as held for investment.

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Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FAS 91). In addition, the acquiring bank should establish loan loss allowances for the acquired held-for-investment loans in periods after the acquisition, but only for losses incurred on these loans due to credit deterioration after acquisition.

However, the guidance contained in SOP 03-3 should continue to be used to account for purchased impaired loans acquired in a business combination. Under SOP 03-3, the yield that may be accreted on a purchased impaired loan, referred to as the "accretable yield," is limited to the excess of the acquiring bank's estimate of the undiscounted principal, interest, and other cash flows expected at acquisition to be collected on the loan over the bank's initial investment in the loan. The excess of the loan's "contractually required payments receivable" over the cash flows expected to be collected on the loan, referred to as the "nonaccretable difference," must not be recognized as an adjustment of yield, a loss accrual, or a loan loss allowance. However, the acquiring bank must determine, as of the acquisition date, whether it is appropriate to recognize the "accretable yield" as income over the life of the purchased impaired loan or whether it should place the loan on nonaccrual status at acquisition and then apply the cost recovery method or cash basis income recognition to the loan. SOP 03-3 also provides guidance on the establishment of post-acquisition loan loss allowances on purchased impaired loans.[8]

Expansion of Scope

Effects of FAS 141(R) on Business Combinations between Two or More Mutual Entities

Among the institutions that will be most affected by the implementation of FAS 141(R) are mutual entities, e.g., mutual banks and credit unions, that engage in business combinations. Because FAS 141 deferred the application of the acquisition method to mergers between two or more mutual entities for future consideration, mutual entities continued to use a method of accounting for such combinations after FAS 141 took effect in 2001 that was substantially similar to the pooling-of-interests method under APB 16. In developing FAS 141(R), the FASB determined that business "combinations between mutual entities are economically similar to combinations between other business entities,"[9] and therefore, the same accounting method should be used to account for business combinations between two or more mutual entities as for combinations between other entities.

In applying the acquisition method to mergers between two or more mutual entities, one of the combining entities must be identified as the acquirer. The acquirer then must determine the fair value of the target entity as a whole. Normally, no consideration is transferred in a combination between mutual entities. Therefore, the fair value of the target entity may be estimated, for example, by using an estimated cash flow model. The resulting fair value is added directly to the acquirer's equity (i.e., the surplus account for a mutual bank), not its retained earnings. Next, the target's assets acquired, including identifiable intangible assets, and liabilities assumed

[8] For further discussion and examples on how to account for and evaluate purchased impaired loans, including the treatment of any "accretable yield" and "nonaccretable differences," refer to "Implications of New Guidance on Accounting for Purchased Impaired Loans," *Supervisory Insights*, Summer 2004.

[9] FAS 141(R), paragraph C34.

Balance Sheet of Combined Mutual Entities at Acquisition Date				
	Target Mutual		Acquiring Mutual	Acquisition Date Combined Mutuals
	Book Value	*Fair Value*	*Book Value*	
	(in millions of dollars)			
Assets	$250	$260*	$1,000	$1,260
Goodwill				8***
Liabilities	225	228	880	1,108
Equity**	25		120	160
Net Assets		32		

* Excluding goodwill.
** Fair value of target mutual as a whole, for example, based on an estimated cash flow Model is $40 million. This amount is recognized as a direct addition to the acquiring mutual's equity.
*** Goodwill is the excess of the fair value of the target mutual as a whole ($40 million) over the fair value of the target's net assets ($32 million).

must be measured at their fair values in accordance with FAS 157. Finally, goodwill is determined based on the amount by which the target's fair value as a whole exceeds the fair value of the target's net assets.

Business Defined

FAS 141(R) broadens the definition of a business. In defining a business, FAS 141 referenced Emerging Issues Task Force Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business* (EITF 98-3), which described "a business as a self-sustaining integrated set of activities and assets conducted and managed to provide a return to investors." Under EITF 98-3, a business consists of inputs, processes applied to inputs, and resulting outputs used to generate revenues.

FAS 141(R) expands the EITF 98-3 definition by removing the requirements that a business have an integrated set of activities and assets that are self-sustaining and that it have outputs. Thus, for instance, many development stage businesses that were excluded from business combination accounting under FAS 141 because they were not self-sustaining and had no outputs may now be considered businesses, depending on the specific facts and circumstances relating to the acquisition under FAS 141(R). Similarly, bank branches, acquisitions of which were commonly accounted for as asset purchases rather than business combinations under FAS 141, may now meet the expanded definition of a business. In such cases, the acquirer would be required to use the acquisition method to account for these transactions under FAS 141(R).

Other Key Changes Made to the Accounting for Business Combinations under FAS 141(R)

The following summarizes other key changes to business combination accounting that will affect the accounting for and evaluation of business combinations by banks and examiners.

Acquisition-related costs—Under FAS 141(R), costs such as legal, accounting, consulting, and investment banking fees must be expensed as incurred. Under FAS 141, these costs were included in the cost of the business combination. Thus, acquisition-related costs were allocated to the amounts assigned to the assets acquired and liabilities assumed, thereby increasing the amount of goodwill recorded under the FAS

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141 framework. Costs to issue debt and equity securities in a business combination are not addressed in either FAS 141 or FAS 141(R), and therefore, the accounting for these costs should follow other GAAP, as appropriate.

Post-acquisition measurement period—During the "measurement period" under FAS 141(R), the acquirer may change provisional amounts initially recorded as of the acquisition date as information necessary to complete the fair value measurements is obtained. The "measurement period" is the period of up to one year after the acquisition date of the business combination. Changes to the provisional amounts may reflect only facts and circumstances that existed as of the acquisition date. Thus, any information that relates to facts and circumstances after the measurement date should be accounted for based on post-acquisition accounting. Under FAS 141(R), changes to the provisional amounts must be reported in the financial statements retrospectively. Under FAS 141, changes made during the "allocation period," which is similar to the "measurement period" under FAS 141(R), were generally accounted for prospectively as information was received. Under both methods, changes in the provisional measurements often affect the amount reported for goodwill.

Preacquisition contingencies—When accounting for preacquisition contingencies under FAS 141(R), the acquirer first must determine whether the preacquisition contingency results from a contractual arrangement or a noncontractual event. Contractual contingencies may result in future assets being acquired (e.g., the funding of unfunded loan commitments) or future liabilities being incurred (e.g., repurchase obligations arising from loans sold in the secondary market) based on the contractual terms entered into by the target institution before being acquired. Under FAS 141(R), all preacquisition contractual contingent assets and liabilities need to be recognized on the balance sheet and measured at their fair value as of the acquisition date.

Noncontractual contingencies that exist as of the acquisition date are recognized and measured at fair value on the acquisition date only *if it is more likely than not*, i.e., a greater than 50 percent likelihood, that the contingency will result in an asset being realized or a liability being incurred in the future. If a noncontractual contingency does not meet the more likely than not criterion, it will not be recognized unless and until it later meets the criteria under other GAAP, such as Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5).

FAS 141 made no distinction between preacquisition contractual and noncontractual contingencies. Instead, FAS 141 required preacquisition contingencies to be recorded on the balance sheet at the acquisition date if one of the following two criteria were met. First, the contingency needed to be recorded if the acquirer could determine the acquisition date fair value of the contingency during the allocation period. If the fair value could not be determined during this period, but before the end of the allocation period it was probable that an asset existed or a liability was incurred, and the amount of the asset or liability could be reasonably estimated, then the asset or liability was recorded in accordance with the guidance set forth in FAS 5.

Equity securities issued—Under FAS 141(R), all equity securities issued to effect a business combination must be measured at fair value as of the acquisition date. This contrasts with FAS 141, under which, if certain criteria were met, the acquirer measured the fair value of marketable equity securities to be issued based on the quoted market prices of these securities over the period shortly before and after the terms of the business combination were agreed upon and announced. Thus, under FAS 141(R), the amount of goodwill to be recognized as of the acquisition date will increase or decrease compared to the amount estimated when the business combination was announced based on the movement of the equity securities' market price in response to such factors as the market's perception of the transaction.

Other differences between FAS 141 and FAS 141(R) include the treatment of contingent consideration granted to the former owners of the target, restructuring costs, in-process research and development activities of the acquiree, and bargain purchases (negative goodwill).

Noncontrolling Interests (FAS 160)

As previously mentioned, a noncontrolling (minority) interest is defined as the portion of the equity in a subsidiary that is held by owners other than the parent company. Under FAS 141(R), when a noncontrolling interest is acquired in a business combination, this interest must be recognized and measured at fair value as of the acquisition date. In addition, ARB 51, as amended by FAS 160, requires the noncontrolling interest to be reported within equity capital in the consolidated balance sheet, but separately from the parent company's equity capital. Under current practice, ARB 51 allows a minority interest to be reported either as a liability or between liabilities and equity capital on the consolidated balance sheet.

Other provisions of FAS 160 include changes in the presentation of the consolidated net income when there is a noncontrolling interest by requiring separate disclosure within the income statement of the amounts of income attributable to the parent and to the noncontrolling interest. It also establishes a single method of accounting for changes in a parent company's ownership interest in a subsidiary that continues to be consolidated. In addition, FAS 160 provides guidance on the accounting for deconsolidation of a subsidiary and establishes new disclosure requirements.

Conclusion

The changes made to the accounting for and reporting of mergers and acquisitions under FAS 141(R) and FAS 160 will change the way in which mergers and acquisitions are accounted for and disclosed. When reviewing applications for mergers and acquisitions occurring after the revised standards take effect, case managers must determine whether the financial information provided by the applicant has been prepared in compliance with the significant changes made by these standards. Foremost among these changes is the requirement to measure all identifiable assets acquired (including loans), liabilities assumed, and any noncontrolling interest in the acquiree at fair value, with limited exceptions. Thus, case managers need to ensure that the acquiring bank follows the guidance for measuring fair value set forth in FAS 157. These and other changes will require banks to modify their approach to assessing the accounting consequences of a potential merger or acquisition when determining how to structure the transaction and deciding whether to proceed with the merger or acquisition.

Leonard J. Bixby
Examination Specialist
Division of Supervision and Consumer Protection
lbixby@fdic.gov