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Bank Notes

March/April 2009

A timely information and idea statement

Six key implications for banks implementing SFAS 141R beginning in 2009

The Financial Accounting Standards Board (FASB) issued a new standard in late 2007 that affects how virtually all companies will account for mergers and acquisitions (M&A) of businesses. For most companies, this new standard goes into effect for their annual reporting periods beginning in 2009.

The FASB's objective in issuing Statement No. 141R, *Business Combinations*, (SFAS 141R) was to "improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in financial reports about a business combination and its effects."

One of the most profound changes brought about by SFAS 141R is the use of a "fair value" model rather than a "cost allocation" model in measuring assets acquired and liabilities assumed in a business combination.

The following summarizes six key implications of this new standard for banks.

1) Previous guidance generally allowed the acquiring bank to carry over the acquired bank's allowance for loan and lease losses (ALLL) for non-impaired loans. SFAS 141R requires assets to be recorded at fair value on the date of acquisition. This means that the acquiring bank will not be able to record a separate valuation allowance for acquired loans on the acquisition date. As a result, banks that are active in M&A will reflect lower ALLL to gross loans ratios than their peers. In addition, this accounting may also impact regulatory capital since the allowance for loan losses is a component of Tier 2 capital, subject to limitations. Any resulting purchase premium or discount on loans that are not impaired will be amortized or accreted to interest income pursuant to SFAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. Purchased impaired loans will continue to be accounted for under SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*. The acquiring bank will be required to establish an allowance for loan losses for acquired loans subsequent to the acquisition date, but only to the extent those loans have incurred credit deterioration after acquisition. Banks that conduct M&A will need to also focus more of their time and energy in ensuring that their ALLL calculation and supporting documentation properly disaggregates purchased loans so as to allow for proper accounting and analysis.

2) The previous standard allowed acquisition related costs to be included in the cost of the target, generally resulting in their inclusion in goodwill. SFAS 141R requires these costs (legal, accounting, investment banking, finders fees, etc.) to be expensed as incurred.

3) SFAS 141R notes "contingent consideration usually is an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met." Prior to SFAS 141R, contingent consideration was usually recognized upon the resolution of the contingency and upon the consideration being issued or becoming issuable. SFAS 141R requires contingent consideration to be recorded in the acquisition-date accounting and measured at fair value. The subsequent accounting for contingent consideration depends on whether it is classified as (a) equity or (b) an asset or liability. Contingent consideration classified as equity is not re-measured in subsequent accounting periods. Contingent consideration classified as an asset or liability is re-measured at fair value on each reporting date subsequent to the "measurement period" with changes in fair value generally being recorded through the income statement. The measurement-period provisions in SFAS 141R generally allow an acquirer to adjust certain aspects of its initial acquisition accounting for a period subsequent to the acquisition date, not to exceed one year. Under SFAS 141R, contingent consideration will generally result in an increase in goodwill on the acquisition date, which may decrease Tier 1 regulatory capital for

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Challenges facing community banks – Part I

The FDIC recently released its Quarterly Banking Profile for the fourth quarter of 2008 and it notes: "industry posts $26.2 billion quarterly loss"; "asset quality indicators show further deterioration"; "institutions with less than $1 billion in assets post lowest quarterly net interest margin since second quarter of 1988"; and "the increase in reserves did not keep pace with the sharp rise in noncurrent loans."

These current economic conditions and the uncertain outlook have undoubtedly led to a realignment of priorities and goals for nearly all banks. In the first of a two-part *Bank Notes* series, we will examine a number of the challenges and the "new realities" confronting bankers.

Risk management

With the growing amount of threats in today's marketplace, community banks must give serious attention to the entire risk management process. Some important considerations include:

- Strategic risks must be understood and planned for.
- Risk management needs an objective advocate and "scorekeeper." Improper organizational structure may result in significant risk and subsequent losses.
- Processes must provide adequate control points.
- Loan documentation follow-up, receipt and analysis must be treated as more than a cursory review.
- Diversification of risks on both the asset and liability side of the balance sheet is imperative; banks must generally avoid an over-reliance on real estate and collateral rather than cash flow.
- Understanding the weaknesses and strengths of the staff at every position and providing appropriate training is a necessity.
- Using technology appropriately in the bank's processes can lead to risk mitigation and enhanced customer service—a double win.

In our experience, risk management is most effective when the CEO conducts regular risk meetings with the management team. All business line managers must take responsibility for knowing the risks associated with their areas. The Chief Risk Officer (CRO), a role that is becoming prevalent in community banks, provides color commentary and insights while keeping the management team honest in their assessments of risks. The CRO acts as risk analyst and strategist, ensuring that line-of-business leadership has the best available information so they can be armed to effectively mitigate risk.

Capital adequacy

Your bank's capital may be adequate, but you will never have enough. That statement isn't necessarily true, but it often feels that way. Sometimes, just when everything seems to be going well, an unexpected event occurs that results in a loss of capital.

Unfortunately, capital is most costly and least available when it is most needed. Therefore, if a cushion for unplanned losses can't be built into a bank's capital, contingency planning becomes extremely difficult. Current shareholders, because they have much at stake, may be the first source of additional capital. New investors, if they can be found, will demand a high price (consider Warren Buffett's high rate of return plus warrants on a recent investment in GE).

Managing capital may be one of your most difficult tasks. There is no magic formula and the stakes are high. Too little capital will result in a forced sale or even failure. Too much capital will result in lower rates of return on equity, perhaps reduced dividends and unhappy shareholders. Look objectively at these realities, consider your bank's risk profile and put together a capital plan your board of directors understands, approves and supports vigorously.

Liquidity

Not long ago liquidity was available from the Federal Home Loan Bank, lines of credit at other banks, fed funds, brokered deposits and other sources. When all else failed, investments could be sold. A "run on the bank" where depositors flocked to close accounts was something we read about in history books—until recently. Once again some banks have been forced to sell or merge because they exhausted their sources of liquidity, even though they had adequate capital.

Managing liquidity risk cannot be ignored. For years bankers have been dealing with liquidity risk resulting from the mismatch of maturities in a bank's balance sheet. Easy to identify, these disparities are typically managed in a relatively routine fashion.

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banks. Because contingent consideration is often a result of the acquirer and target being unable to agree upon the purchase price due to specific uncertainties, determining a fair value of the contingent consideration as of the acquisition date could prove to be problematic in many situations. It should be noted that contingent payments deemed to be compensation will continue to be expensed based on the substance of the arrangement.

4) A partial acquisition occurs when a buyer in a business combination acquires less than 100 percent, but more than 50 percent, of the target. Previous guidance calculated the noncontrolling interest in the net assets acquired at book value. However, SFAS 141R requires the noncontrolling interest (previously referred to as “minority interest”) to be measured at fair value. This provision in SFAS 141R will generally result in an increase in goodwill and a decrease in Tier 1 regulatory capital for banks.

5) Another significant implication for banks relates to the measurement of equity securities that are issued as consideration. Measurement under the previous guidance was the market prices of the securities as of a few days before and a few days after the announcement date. Measurement under SFAS 141R is the fair value of securities as of the acquisition date. As such, significant fluctuations in the acquirer’s stock price subsequent to the announcement date may significantly increase or decrease goodwill from the original expectations when the transaction was negotiated. It is likely that acquiring banks and their advisors will consider this provision when setting caps, floors and exchange ratios.

6) Another significant change made by SFAS 141R has to do with the definition of a business. Under SFAS 141R, in order for the transferred set to be considered a business, it must include inputs and processes that are capable of producing outputs. Existing outputs do not have to be part of the transferred set under SFAS 141R, which is in contrast to the prior guidance. While there was diversity in practice, bank branch acquisitions were often previously accounted for as asset purchases. SFAS 141R will result in many more branch acquisitions being accounted for as business combinations.

In conclusion, the move toward an accounting model based on fair value instead of cost is becoming more and more pervasive in the accounting standard-setting area and is evident in SFAS 141R. The move to, and complexity of, the required fair value determinations will result in an increase in the use of valuation specialists — both by management and auditors. As noted above, banks that are active in the M&A area, will have a much higher likelihood of earnings volatility and will need to closely manage the structure of their transactions due to the various potential goodwill and resulting regulatory capital implications.

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Managing liquidity gets significantly more interesting when needs arise because of unexpected cash concerns. The degree and complexity of the risk varies with the source of the liquidity need. Obtaining additional liquidity because of unexpected draws on loan commitments may be relatively easy to satisfy. However, obtaining additional liquidity because of unexpected deposit withdrawals may be extremely difficult.

Flexibility is clearly an asset when you are dealing with liquidity issues. The cost of liquidity increases as the sources decline. Keeping a broad cross-section of unpledged securities is an example of one way to add flexibility.

Your liquidity plan should be comprehensive, but simple enough for your bank’s board of directors to understand the risks and responses. Because liquidity needs change rapidly, the board should be informed of the bank’s liquidity position and plans on a regular basis, generally at each board meeting.

The next issue of *Bank Notes* will examine boards of directors, technology needs and uses, earnings, as well as facing the future in the final installment of “challenges facing community banks.” For a more in-depth discussion related to this article, please download a comprehensive white paper at www.rsmmcgladrey.com.

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SEC Conforms Staff Guidance on Business Combinations and Noncontrolling Interests to FASB Standards

SEC staff guidance on business combinations and noncontrolling interests is conformed to FASB Statements 141R and 160 by new Staff Accounting Bulletin 112.[1] The revisions will not significantly affect current financial reports, because Statements 141R and 160 are already effective for calendar-year companies.

To take some examples of the Bulletin's revisions: it replaces the previous reference to the "purchase method" of accounting for business combinations with the "acquisition method," eliminates conflicting guidance for disclosures, conforms the terminology on "basis of accounting" requirements, and removes both the staff's guidance on valuing loans acquired in a business combination and the policy-election provision for gain or loss recognition when a subsidiary sells shares of its own stock with the parent retaining control (often referred to as "SAB 51 transactions").

The Bulletin also conforms the staff responses to five questions related to oil and gas exchange offers, including disclosure, "common control accounting," and requirements for pro forma financial information in an exchange offer filing. The answers are now consistent with Statement 141R's requirement that if control is obtained, the properties are measured at fair value.

Staff Accounting Bulletin 112 will become effective when it is published in the Federal Register.

The descriptive and summary statements in this newsletter are not intended to be a substitute for the text of SEC Staff Accounting Bulletin 112, FASB Statements 141R and 160, or any other applicable or potential accounting literature or SEC regulations or staff guidance. Companies applying GAAP or filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors.

[1] SEC Staff Accounting Bulletin No. 112, June 4, 2009, available at www.sec.gov; FASB Statements No. 141 (revised 2007), Business Combinations, and No. 160, Noncontrolling Interests in Consolidated Financial Statements, both available at www.fasb.org.