

New Landscape for Business Combinations and Noncontrolling Interests

By Rick L. Childs

Acquisition method presents challenges for mutually owned thrifts and credit unions.

As a part of the initiative to create international convergence of accounting standards, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) worked together to refine guidance for business combinations. On December 4, 2007, the FASB issued FASB Statement of Financial Accounting Standards No. 141 (revised 2007), *Business Combinations* (FAS-141(R)) [ASC Topic 805], and FAS-160, *Noncontrolling Interests in Consolidated Financial Statements* [ASC Topic 805 and ASC Topic 810].¹ These standards have significantly changed the landscape for accounting for business combinations and noncontrolling interests.

The standards became effective for fiscal years beginning after December 15, 2008, which means that the standards have been in effect since January 1, 2009, for calendar-year-end companies. For fiscal-year-end companies, the standards will become effective during 2009 as their year-ends close.

The new business combination standard has had a significant impact on credit unions and mutual thrifts. FAS-141, originally issued in June 2001, required that all business combinations be accounted for using the acquisition method. However, the effective date was deferred for mutual enterprises, such as mutually owned thrifts and credit unions, until further guidance could be issued. FAS-141(R) [ASC Topic 805] is that guidance. No longer will credit unions and mutually owned thrifts be able to apply the pooling method, and they will have to comply with purchase-method accounting. These requirements present unique issues for these organizations.

From FAS-141 to FAS-141(R)

Exhibit 1 shows the key differences between FAS-141 and FAS-141(R) [ASC Topic 805] and their potential impact. The more notable changes include the following:

- Allowance for loan losses
- Defensive assets
- Acquisition costs
- Measurement date for consideration transferred
- Restructuring costs
- Contingencies
- Mutual organizations

Allowance for Loan Losses

One of the most significant changes to business combination accounting is the treatment of a financial institution's allowance for loan losses. In FAS-141R [ASC Topic 805], the FASB concluded that acquired receivables (including loans) should be measured at fair value at the date of acquisition. Thus, a separate allowance for uncollectible amounts should not be established upon initial recognition of those receivables.

Therefore, the allowance is \$0 at the date of acquisition and is assumed to be a part of the fair value of the loan portfolio acquired. The question then becomes how to account for that adjustment after the acquisition date. Interpretative guidance can be

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New Landscape for Business Combinations and Noncontrolling Interests

Exhibit 1. Key Differences Between FAS-141 and FAS-141(R) [ASC Topic 805]

Key Provision	FAS-141	FAS-141(R), as amended [ASC Topic 805]	Potential Impact
Definition of a business	A business is defined by reference to EITF 98-3, <i>Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business</i> , as a self-sustaining set of activities. That is, inputs, processes and outputs are generally required. A business combination occurs when an entity obtains control of a business, as defined, through acquisition of equity interests or net assets.	A business is an integrated set of activities and assets, capable of being conducted and managed for the purpose of providing a return. (Self-sustainability is not required.)	More groups of assets will be considered businesses, further qualifying as business combinations by the transactions or events.
Definition of a business combination	A business combination occurs when an entity obtains control of a business, as defined, through acquisition of equity interests or net assets.	A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses. A "merger of equals" is also considered to be a business combination.	More transactions or events will be considered business combinations, requiring application of the acquisition method.
Mutual organizations	Mutual entities are in the scope of FAS-141, but the effective date was delayed pending further guidance.	Combinations between mutual entities are in the scope of FAS-141(R).	Use of the acquisition method will be required for mutual entities.
Acquired net assets recorded at fair value for step acquisitions	Fair value of net assets, including goodwill, is recognized under a cost accumulation approach. That is, fair value is applied to the acquired portion. Any minority interests are recorded at their carrying amounts.	With limited exceptions, 100 percent of the acquired entity's net assets, including goodwill, are recorded at fair value, for full, partial or step acquisitions. Any previous noncontrolling interest held by the acquirer is remeasured to fair value, with gain or loss recognized in earnings.	For business combinations achieved in stages (that is, step acquisitions), the prior interest will be remeasured at fair value and earnings potentially affected. Also, there will be increases to the balance sheet to record 100 percent of the net assets with an increase in equity to record the noncontrolling interest.
Goodwill	Only the amount of goodwill associated with the acquirer's interest is recognized.	Goodwill associated with the controlling and noncontrolling interests is recorded.	More goodwill is recognized. This may present challenges to goodwill accounting, including reporting unit allocation and impairment testing.
Allowance for loan losses	Loans are normally stated at present value less a credit allowance.	Loans are stated at fair value with no separate valuation allowance.	With no separately recorded valuation allowance for loans, the accounting may be challenging, and more disclosure will be required.
Assets the acquirer does not intend for use (defensive assets)	Intended use affects value assigned. No intended future use generally results in limited value.	The acquirer's intentions do not affect the fair-value measurement. The "highest and best use" concept of FAS-157, based on market participant assumptions, is to be reflected.	Generally, higher recognized value will result. Future earnings will be affected, as these assets are depreciated/amortized or impaired.
Acquisition and restructuring costs	Most direct acquisition costs (such as legal, finder's, advisory, accounting fees) and planned restructuring costs are recorded as assets and liabilities, respectively, and capitalized in goodwill.	Acquisition and restructuring costs are generally expensed as incurred and recognized separately from the business combination and acquisition method accounting.	Earnings will be affected negatively as costs are incurred. This change will result in less goodwill under the acquisition method.

New Landscape for Business Combinations and Noncontrolling Interests

Exhibit 1. Key Differences Between FAS-141 and FAS-141(R) [ASC Topic 805] (Continued)

Key Provision	FAS-141	FAS-141(R), as amended [ASC Topic 805]	Potential Impact
Income taxes (subsequent accounting)	Valuation allowances: Decreases first reduce goodwill to zero and then reduce noncurrent intangibles and, finally, are recorded in earnings. Increases are recorded as income tax expense. Uncertain tax positions: The resolution is reflected in purchase accounting, regardless of the timing of the resolution.	Valuation allowances and uncertain tax positions: If recognized in the measurement period, the acquirer may adjust preliminary amounts recognized in the business combination (not to exceed one year); adjustments are generally made to goodwill. Subsequent adjustments beyond the measurement period are generally recorded through income tax expense. Deferred taxes are recognized for tax-deductible goodwill in excess of book basis.	Similar to other changes in assets and liabilities acquired in a business combination, subsequent adjustments will have an impact on postacquisition earnings.
Measurement date for consideration transferred	Generally, for publicly traded equity securities, measurement is the announcement date. Other consideration is measured on the acquisition date.	All consideration is to be measured on the acquisition date—that is, the date when control is obtained, generally the closing date.	This change will result in a more definitive measurement for equity securities; however, changes in the price of the equity securities from announcement date to acquisition date will affect the amounts recognized.
Contingencies (such as lawsuits, recourse obligations)	Recognize at fair value if determinable during the allocation period. If fair value is not determinable, record an asset or liability if it is probable that an asset existed or that a liability had been incurred at the acquisition date and the amount is reasonably estimable, using FAS-5, <i>Accounting for Contingencies</i> , and FASB Interpretation No.14, <i>Reasonable Estimation of the Amount of a Loss</i> (FIN-14).	Recognize at fair value if determinable during the measurement period. If the fair value is not determinable, record an asset or liability if it is probable that an asset existed or that a liability had been incurred at consummation date and the amount is reasonably estimable, using FAS-5 and FIN-14.	No significant change expected from FAS-141 for financial institutions.
Contingent consideration	Contingent consideration is generally recognized as additional purchase price (and increases goodwill) when the contingency is resolved.	Contingent consideration is to be measured at fair value at the acquisition date. Most subsequent changes in fair value will be accounted for in accordance with the contingency's classification. Contingent consideration classified as equity will not be remeasured, but settlement differences will be accounted for within equity. Changes in fair value of the contingent asset or liability will generally be adjusted through earnings.	Postacquisition earnings are exposed to changes in fair value, and fair value measurements may be challenging or complex.
Bargain purchases	Fair value in excess of cost (often referred to as negative goodwill) is first applied to reduce noncurrent assets on a pro rata basis. Any remainder is an extraordinary gain in earnings.	Excess fair value of identifiable net assets acquired is recognized as a gain attributable to the acquirer through earnings. Such a circumstance first requires revisiting identified net assets and valuation thereof.	All bargain purchases will result in a recognized gain in the acquisition period earnings.

Exhibit 2. Postacquisition Treatment Loan Value Affects Comparability of Peer Groups

An institution that has completed a business combination will differ from an institution that has not.

	Target Book Value	Target Fair Value	Acquirer	Combined
Loans	\$1,000	\$860	\$2,000	\$2,860
ALLL*	(10)	0	(20)	(20)
Net Loans	990	860	1,980	2,840
Ratio	1.0%	0.0%	1.0%	0.7%

* Allowance for loan and lease losses

found both on the Federal Deposit Insurance Corporation (FDIC) Web site² and also in the American Institute of Certified Public Accountants (AICPA) Technical Practice Aid pertaining to Statement of Position No. 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3) [ASC Topic 310].³

After the acquisition, the discount or premium on loans that are held for investment loans and are not in the scope of SOP 03-3 [ASC Topic 310] will be amortized and accreted into income consistent with FAS-91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* [ASC Topic 310]. If the loans meet the criteria of SOP 03-3 [ASC Topic 310], then they will be accounted for in accordance with that guidance.

Some financial institutions have raised concerns about the lack of an allowance for loan losses on the acquired loans. In periods after the acquisition, financial institutions can establish loan-loss allowances for the acquired loans—but only to the extent that there have been additional losses on the acquired loans.

Financial institutions might be tempted to establish a provision in the first several quarters following the acquisition. Those institutions should remember that there is a one-year measurement period to finalize adjustments and, as a result, large adjustments that are not due to credit deterioration likely would be seen as insupportable or as evidence that the initially established loan values are inaccurate and that retroactive adjustments to the acquisition date are required.

Many have observed that a lack of an allowance for loan losses decreases the comparability of peer group data. As a result, additional disclosures are required to aid in comparability. FAS-141(R) [ASC Topic 805] does require additional disclosures, for

the period in which the business combination occurs, including the following:

- Fair value of the receivables
- Gross contractual amounts receivable
- Best estimate at the acquisition date of the contractual cash flows not expected to be collected

Also, Schedule RC-C, *Loans and Lease Financing Receivables*, in the Call Report has been amended to collect similar information.

An institution that has completed a business combination will differ from an institution that has not. The example in Exhibit 2 highlights the issue of postacquisition comparability.

Defensive Assets

The focus of the new standard, from a valuation perspective, was to value all of the entity for what the assets and liabilities are worth, without regard to how an acquirer intends to use the assets and liabilities after acquisition. This comes through clearly for assets to which in the past acquirers would assign very little value. Under FAS-141(R) [ASC Topic 805], those assets have to be valued using a FAS-157, *Fair Value Measurements* [ASC Topic 820], framework that focuses on how a market participant would value those assets.

An example of such an asset is the trade name of a financial institution. In most transactions, the acquired institution is merged into the acquirer and takes on the acquirer's name and trademarks. In the past, the acquirer would assign no value to the trade name because it did not intend to use the name. Now the trade name has to be valued using market participant assumptions.

One way to reduce the impact of recording an intangible asset that would need to be impaired on day two is to make sure that the assumptions used for the valuation are realistic. Many trade

names are valued using a relief-from-royalty method, which assigns a royalty percentage to the trade name for its use and assumes that the value of the trade name comes from avoiding payment of the royalty. Key to the valuation is the assignment of an appropriate royalty rate. As of June 30, 2009, there were approximately 460 First National Banks and more than 190 First State Banks. If one of those were the trade name being valued, then it would seem likely a very low royalty rate would be applied.

Defensive assets are assets acquired in a business combination that the acquirer (1) does not intend to use or (2) intends to use in a way other than the assets' highest and best use as determined by evaluating market participant assumptions. Defensive assets sometimes are called locked-up assets because, while the asset is not being actively used, it is likely contributing to an increase in the value of other assets the acquiring entity owns.

Because questions were raised about how a defensive asset should be accounted for after acquisition and whether a defensive asset should be considered a finite-lived asset or an indefinite-lived asset, Emerging Issues Task Force No. 08-7, *Accounting for Defensive Intangible Assets* (EITF 08-7) [ASC Topic 350], was issued. The EITF concluded that a defensive intangible asset should be accounted for as a separate unit of accounting and should be assigned a useful life that reflects the entity's consumption of the expected benefits related to that asset (but remember the benefits will decline without care and feeding). The benefit received from holding a defensive intangible asset is the direct and indirect cash flows resulting from preventing others from realizing any value, defensively or otherwise, from the intangible asset.

The useful life should be determined by estimating the period over which the defensive intangible asset will diminish in fair value. The determination of whether an intangible asset is a defensive intangible asset is based on the intentions of the reporting entity; that determination might change as the entity's intentions change. For example, an intangible asset that was accounted for as a defensive intangible asset on the date of acquisition will cease to be a defensive

asset if an acquirer of the entity subsequently decides to actively use the asset.

Acquisition Costs

Acquisition-related costs paid to third parties (for example, finder's, advisory, legal, accounting and other professional fees associated with negotiating or completing the deal) should be expensed as incurred. These amounts are not part of the value of the business combination transaction. This is a change in practice, as many of these costs were capitalized under FAS-141. One result of this change will be to provide more visibility to the costs incurred in a transaction.

Measurement Date for Consideration Transferred

Another change is the definition of the acquisition date. In the past, the acquisition date for measuring the consideration paid was a few days before and after the announcement date, unless changes occurred to the price postannouncement. Now the acquisition date refers to the date control is gained over the target entity. Thus, equity securities issued as consideration in a business combination should be measured at their fair value on the acquisition date.

Restructuring Costs

Under FAS-141, certain costs that will be incurred by the acquirer could be classified as a liability and recorded as a purchase adjustment. With the focus now on the value of the acquired entity devoid of other economic transactions, those costs to be incurred by the acquirer are not assumed liabilities.

Costs expected to be incurred by the acquiring entity pursuant to a plan to exit an activity of an acquired entity, terminate employees of an acquired entity or relocate employees of an acquired entity are not assumed liabilities; therefore, these costs should not be recognized as liabilities by the acquiring entity when the business combination is initially recorded. In other words, the purchaser should record what actually was assumed rather

Exhibit 3. Comparison of Guidance for Contingencies

FAS-141(R), as amended by FSP FAS 141(R)-1 [ASC Topic 805]

- Recognize at fair value if determinable at closing or becomes determinable during the allocation period.
- If fair value is not determinable, record an asset or liability if it is probable that an asset existed or that a liability had been incurred at the acquisition date and the amount is reasonably estimable, using FAS-5 and FIN-14 [ASC Topic 450].

FAS-141(R) [ASC Topic 805]

Initial measurement:

- Contractual contingencies are recognized at fair value.
- Noncontractual contingencies are recognized at fair value if they meet a more-likely-than-not recognition (generally a 50 percent threshold). Otherwise, use FAS-5 [ASC Topic 450].

Subsequent measurement:

- A liability is measured at the higher of: 1) its acquisition-date fair value or 2) the amount recognized if applying FAS-5 [ASC Topic 450].
- An asset is measured at the lower of: 1) its acquisition-date fair value and 2) the best estimate of its future settlement amount.
- An asset or liability arising from a contingency is derecognized only when the contingency is resolved.

FAS-141

- Recognize at fair value if determinable during the allocation period.

If fair value is not determinable, record an asset or liability if it is probable that an asset existed or that a liability had been incurred at the consummation date and the amount is reasonably estimable, using FAS-5 and FIN-14 [ASC Topic 450].

than what changes the acquirer plans to make after the transaction. When those costs are incurred, they should be expensed.

Contingencies

The accounting for contingencies has already been revised in 2009. FASB issued FASB Staff Position 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination that Arise from Contingencies* (FSP 141(R)-1) [ASC Topic 805]. The original language in FAS-141(R) [ASC Topic 805] provided separate guidance for initial measurement for contractual and noncontractual contingencies as follows:

- The acquirer shall recognize as of the acquisition date all of the assets acquired and liabilities assumed that arise from contingencies related to contracts (referred to as contractual contingencies), measured at their acquisition-date fair values.
- For all other contingencies (referred to as noncontractual contingencies), the acquirer shall assess whether it is more likely than not as of the acquisition date that the contingency gives rise to an asset or a liability as defined in Concepts Statement 6, *Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)*. If that criterion is met as of the acquisition date, the asset or liability arising from a noncontractual contingency shall be recognized at that date, measured at its acquisition-date fair value.

The original guidance in FAS-141(R) [ASC Topic 805] also had separate guidance for subsequent measurement. The FSP changed the guidance for contingencies in FAS-141(R) [ASC Topic 805] to align closely with the prior FAS-141 guidance that measures all contingencies, both contractual and noncontractual, consistently (Exhibit 3). The FSP also provides relief from the initial and subsequent methods prescribed by FAS-141(R) [ASC Topic 805].

Mutual Organizations

In combinations of mutual organizations, the initial measurement of fair value of consideration

Exhibit 4. New Treatment of Noncontrolling Interest Under FAS-160 [ASC Topics 805 and 810]

	Old U.S. GAAP	FAS-160
Income	\$300	\$300
Expense	\$200	\$200
Income before taxes	100	100
Income taxes	35	35
Income before minority interest	65	NA
Minority interests	5	NA
Consolidated new income	60	65
Less: Net income attributable to noncontrolling interest		5
Consolidated net income attributable to controlling interests		<u>\$60</u>

is challenging because, generally, only member interests are exchanged and no observable and measurable exchange prices are available. In other words, the acquiring mutual enterprise pays little or no cash.

In accounting for the acquisition of a mutual enterprise, the fair value of the acquired mutual enterprise should be reported by the acquirer as a direct addition to an equity or capital account.

The FASB concluded that the fair value of the whole enterprise should be used to determine goodwill.

Here is a simple example of how this works:

- **Determine the fair value of an acquired mutual thrift or a credit union as a whole.** For example, assume \$11 million.
- **Determine the fair value of assets and liabilities.** Assume a net fair value of \$4 million.
- **Determine goodwill.** In this example, the excess “cost” (value of the whole entity in excess of the value of individual assets and liabilities) is \$7 million, so the goodwill is \$7 million.
- **Record fair value.** The acquirer would record the fair value of the acquired assets and liabilities (\$4 million, net) and goodwill (\$7 million) with an offsetting addition to equity (\$11 million).

Determining the fair value of the entire enterprise can be complicated, because there is no market for the mutual interests. Because the mutual thrifts and credit unions do possess many of the same characteristics of stock-based banks and thrifts, the latter entities can be used as a proxy with appropriate adjustments for comparability.

FAS-160: Noncontrolling Interests [ASC Topics 805 and 810]

The FASB also issued new guidance for noncontrolling interests (previously called “minority interests”), which is the portion of equity in a subsidiary not attributable, directly or indirectly, to a parent. One of the most significant changes is that noncontrolling interests (when consolidated with the parent) are now included with equity instead of presented as mezzanine equity or liabilities.

Acquirers will recognize a gain or loss on their former noncontrolling interests when control is gained. At that point, FAS-141(R) [ASC Topic 805] is applied for the transaction.

For example, a 20-percent ownership investment has a book value of \$2,000. Through the acquisition of a controlling interest, that 20-percent interest is now worth \$2,500. The \$500 increase would be a gain reported through the income statement.

Once control is obtained, gains or losses from additional transactions involving the noncontrolling portion of the parent’s interest flow only through equity and not the income statement.

Exhibit 4 shows how the income statements would be reflected pre-FAS-160 versus post-FAS-160 [ASC Topics 805 and 810].

Intangible Assets

Although FAS-141(R) [ASC Topic 805] did not change the accounting for intangible assets, it does

Exhibit 5. Distressed Transactions Lead to Decline in Goodwill

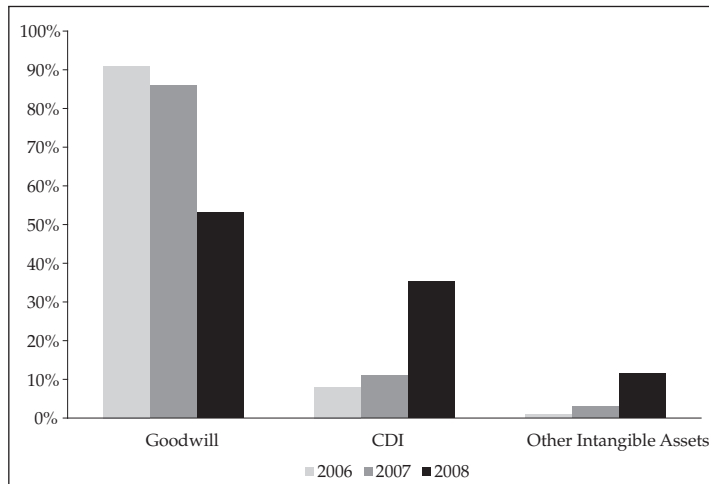
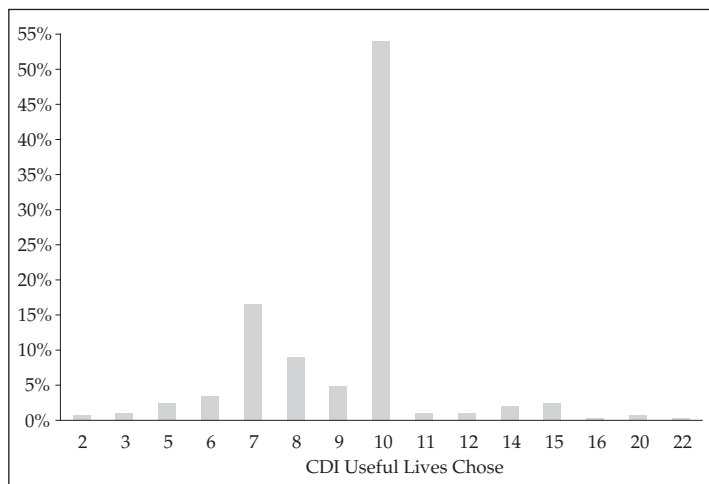


Exhibit 6. CDI as a Percentage of Core Deposits



Exhibit 7. Amortization Periods for the CDI Chosen by the Acquirer



suggest that more intangible assets will be recorded under it than have been under FAS-141. A study of bank and thrift acquisitions over the period from 2006 to 2008, based on information disclosed in SNL Financial's database, suggests that other intangible assets were rarely recorded under FAS-141. When they were recorded, the other intangible assets tended to be related to ancillary businesses, such as insurance brokerages or asset management.⁴ Using transactions in which the buyer was a public registrant, we reviewed the public filings to identify the intangibles that were recorded. Exhibit 5 shows the percentages applied to goodwill, core deposit intangible (CDI) and other intangibles.

Goodwill represents the majority of the intangibles recorded in these reviewed transactions, with CDI comprising the other major component. For 2008, the distressed nature of many transactions led to less goodwill being recorded. The other intangible assets effectively then became a larger component of a reduced amount of intangibles recorded.

The review also provided relevant information on the level of the CDI measured as a percentage of core deposits (defined as checking, interest-bearing checking, savings and money market accounts) (Exhibit 6).

Exhibit 7 shows the amortization periods for the CDI chosen by the acquirer.

Assess Accounting Impact as Part of Due Diligence

FAS-141(R) [ASC Topic 805] and FAS-160 [ASC Topic 805 and ASC Topic 810] present unique challenges to acquisitive institutions. Proper planning up front and determining realistic assumptions about the accounting in the predeal pro forma projections and valuations are keys to understanding the postacquisition impact. Giving consideration to the accounting impact as a part of due diligence can mitigate the risks of not meeting deal expectations.

Endnotes

¹ On July 1, 2009, the FASB's codification became effective and is now the single source of authoritative nongovernmental

U.S. generally accepted accounting principles (U.S. GAAP). Because users will take time to become familiar with all of the sections of the codification, both the superseded FAS numbers and the current codification paragraphs are provided.

² www.fdic.gov/regulations/examinations/supervisory/insights/siwin08/accounting_news.html.

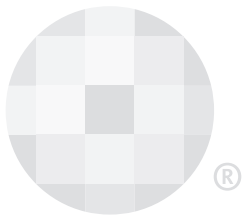
³ www.aicpa.org/download/acctstd/TPA_03-3.pdf.

⁴ Crowe reviewed 352 acquisition transactions completed from 2006 to 2008 where the acquirer was a public registrant. We reviewed 10-K, 10-Q and other public filings to identify the types and dollar amounts of intangibles recorded and other related data points.

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