ACQUISITION ACCOUNTING UNDER FASB 141(R)

Prior to 2002, Accounting for bank transactions used the pooling of interests method. This was a fairly simple method where the acquiror basically combined the balance sheets for the two institutions and went on their way.

In 2002, the pooling of interests method was replaced by the Purchase Method of accounting. That method was used until the end of 2008, when it was replaced by the "Acquisition Method" beginning in January 2009. The Acquisition Method and the Purchase Method are very similar, with some minor differences.

The first step in acquisition accounting is determining the acquiror. Each and every bank transaction (even a "combination" between two mutuals) must have an identified acquiror and an identified target.

After the acquiror has been identified, the second step is determining the acquisition date. This is typically the day the Articles of Merger are filed, or the date specified in the Articles of Merger as the transaction effective date. This date is important because everything in the transaction is tied to the acquisition date.

The third step in accounting for a bank transaction is valuing each of the target's assets and liabilities. FASB 141(R), the accounting pronouncement that implemented the Acquisition Method of accounting, requires that the target's assets and liabilities be transferred to the acquiror at their "fair value" on the acquisition date.

One of the difficulties in accounting for a bank merger is determining the fair value of the assets acquired as of the date of the transaction. Certainly cash is not hard, but this task can be difficult when acquiring securities or, more importantly, loans.

The fair value of loans is not necessarily what the target bank paid to acquire the loan or the face value or ledger balance of the amount outstanding. Instead, the loan's fair value is determined by an accountant following the transaction, and is dependent on a number of factors, including, but not limited to:

- Interest rate of the loan;
- Term of the loan;
- Loan type;
- Collateral;
- Borrower credit ratings;
- Adjusted vs. fixed rate; and
- Premium/discount on interest rate variances.

The rules for purchase accounting allow some homogeneous loan pools to be valued on an aggregate basis. However, FASB 141(R) requires the more complicated commercial loans to be individually valued. This will certainly drive up acquisition costs because it will require more professional labor.

After the initial valuation of the loans, the bank is required to record, adjust and track the "difference" between the face value and fair value of each loan or loan pool. These periodic adjustments result in income or expense based on the initial valuation, and whether the loans were valued at less or more than the outstanding balance at the time of the acquisition.

Generally, a bank's liabilities are easier to value. The fair value of a deposit liability is generally thought to be the amount owed on the account. There may be some variation for other liabilities, but for the most part, the liabilities are what they are as presented on the balance sheet.

Once an acquiror has determined the fair value for a target's assets and liabilities, it can determine the equity and whether any goodwill will be recognized. The equity in a bank transaction is the net difference between the fair value of the assets and the fair value of the liabilities. For example, where the fair value of the target's assets is determined to be $88 million and the fair value of the liabilities is determined to be $80 million, the equity would be $8 million, the difference between the two.

Once the amount of equity has been identified, the next step is valuing the purchase consideration. According to FASB 141(R), there are two separate components to total consideration. These include (1) the fair value of the consideration offered on the date of purchase (cash, acquiror stock or something else) plus (2) the fair value of any non-controlling interest the acquiror may hold in the acquiree (for example, if a bank holding company owned 25% of a bank and bought the other 75%, the fair value of the 25% ownership would be included in the purchase price). FASB 141(R) requires that the consideration be valued as of the acquisition date.

The requirement that the consideration be valued as of the acquisition date is a departure from the old accounting rules. Formerly, acquirors could choose a "convenience date" somewhere close to the date of acquisition or could use an average of some time period close to the acquisition to value the consideration. This was especially helpful when stock was used as consideration. FASB 141(R) did away with such "convenience accounting" and now requires that the stock consideration (or other consideration) be valued as of the date of closing.

After establishing the target's equity and the value of the consideration, the final step in the acquisition accounting method is to determine whether the transaction results in negative goodwill or goodwill. A transaction results in negative goodwill if the purchase consideration is less than the equity. The negative goodwill is equal to the difference between the two. For example, an acquiror would recognize $500,000 in negative goodwill if they completed a purchase of a target with $9 million in equity for $8.5 million. FASB 141(R) requires the negative goodwill to be recognized as income immediately.

As a practical note, if a bank determines that a transaction will result in negative goodwill, FASB 141(R) requires that the bank go back and reestablish fair values for the assets and liabilities before the negative goodwill is recognized as income. This requirement serves as a "double check" to make sure the assets and liabilities have been valued properly.

Most transactions will typically not result in negative goodwill. Instead, it is more likely that the purchase price will exceed the target's equity. In this situation, the excess of the purchase price over the equity (which is referred to as the "purchase premium") will be split between two intangibles: a core deposit intangible and goodwill.

The core deposit intangible represents the amount a bank may be willing to pay for the opportunity to acquire core deposits. This asset is amortized over the useful life of the asset for book purposes (generally seven to 10 years), and is amortized over a 15-year period for tax purposes.

The amount of goodwill an acquiror must recognize is equal to the purchase price premium minus the amount allocated to the core deposit intangible. Goodwill is not amortized, but is rather tested periodically for impairment.

It is impossible to determine exactly what amount of a purchase premium is attributed to the core deposit intangible and what amount will be attributed to goodwill using some mathematical formula. Instead, the accounting firm handling the transaction will perform a core deposit intangible study to determine the value of the intangible. These values are generally based on the cost to acquire the deposits, as well as the income that may be attributable to them.