



WILARY WINN LLC

ADVICE TO
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FINANCIAL
INSTITUTIONS

CUNA Finance Council Conference

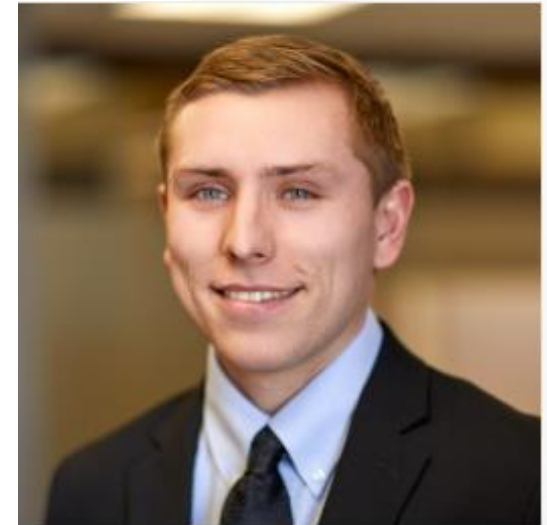
M&A Accounting Implications in the Current
Economic Environment

5/22/2023

TODAY'S PRESENTER

Cole Schulte, Director

Cole Schulte leads the firm's fair value business line, which includes mergers and acquisitions, goodwill impairment testing, and fair value advice related to footnote disclosures. In addition, he helps lead the company's CECL product line and is responsible for model enhancements. In his role as Director, Cole manages a team working on these engagements. He joined Wilary Winn in 2016. Cole has a bachelor's degree in finance from the Carlson School of Management at the University of Minnesota.



WILARY WINN LLC

MERGERS & ACQUISITIONS

What Kinds of Services Do We Provide?

- Our primary services include fair value estimates relating to credit union mergers, credit union purchases of banks, and branch acquisitions
- We offer two valuations – a preliminary and a final valuation of the institution merged-in



MERGERS & ACQUISITIONS

Our Approach

- Purchase accounting requires that the merged-in institution's balance sheet be recorded at fair value. We determine this by estimating the fair value of:
 - Assets acquired, including loans and investments
 - Liabilities assumed, including the core deposit intangible arising from the non-maturing shares
 - Fair value of equity and the resulting amount of goodwill or bargain purchase gain
- Our preliminary valuation:
 - Is designed to help our clients better understand the accounting and regulatory capital implications from the proposed transaction
 - Includes an unbiased reasonability check of the proposed purchase price (for bank acquisitions), utilizing market and guideline transaction approaches
- Our final valuation is performed as of the legal closing date. It is used to record the day one journal entries and provides the basis for the ongoing accounting.



TOPICS COVERED TODAY

- Trends and Economics
- Basics of Purchase Accounting
- Accounting Implications
- Accounting Updates

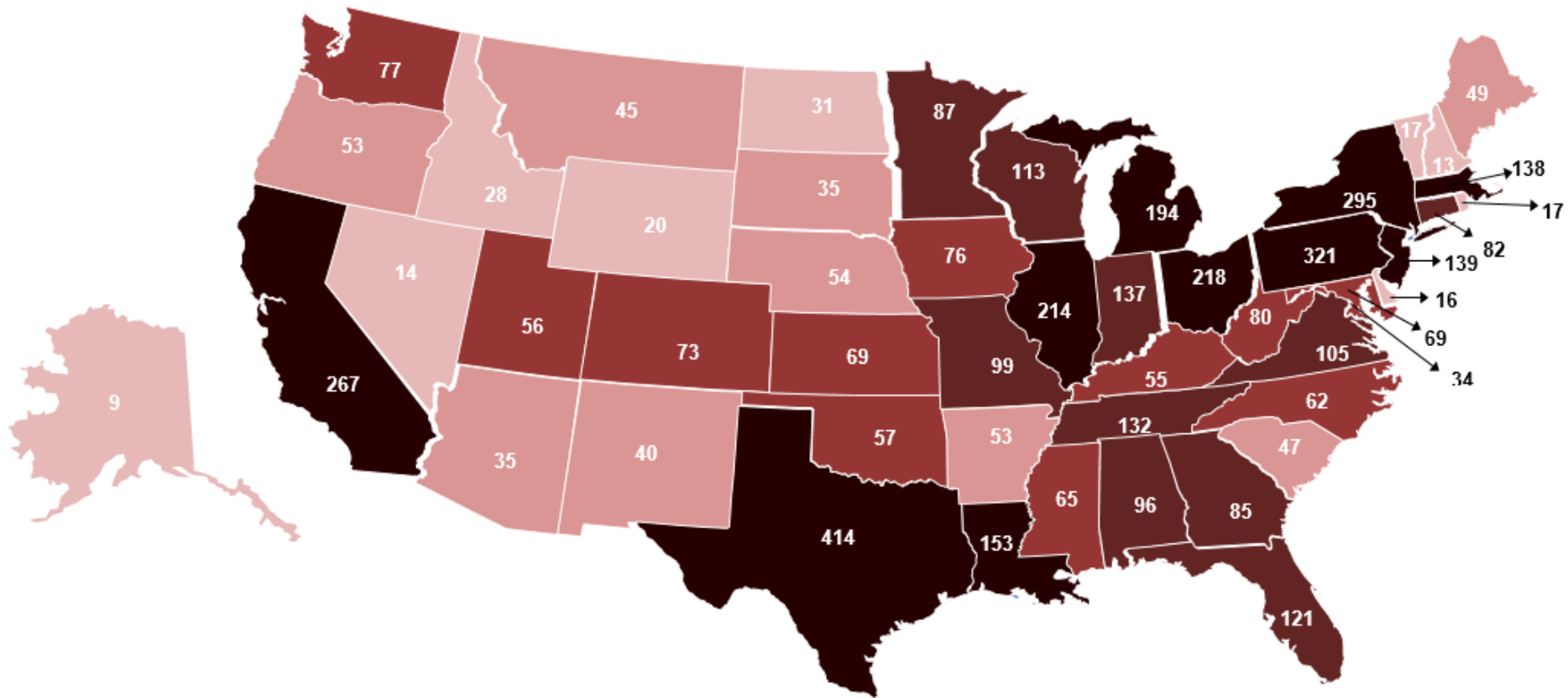




TRENDS AND ECONOMICS

TRENDS AND ECONOMICS

Distribution of Credit Unions



TRENDS AND ECONOMICS

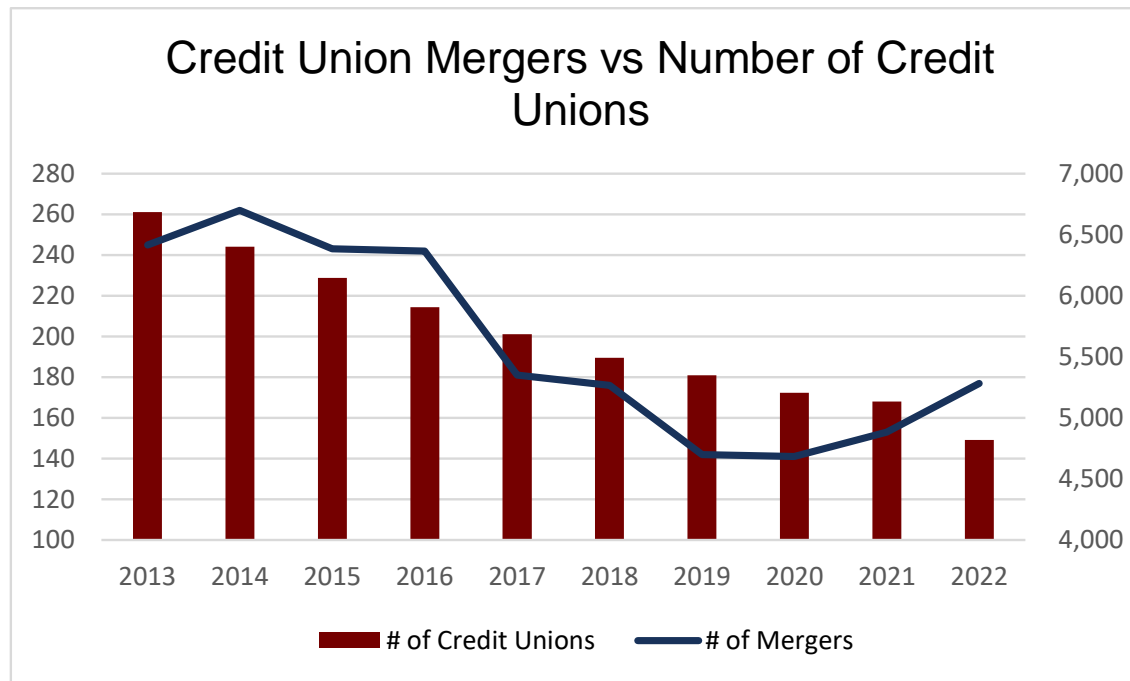
Existing Credit Unions by Asset Size

Asset Size Range	Count	% of CUs	% of Assets
>\$10B	21	0.44%	24.06%
\$1B - \$10B	405	8.40%	50.75%
\$500M - \$1B	292	6.06%	9.63%
\$100M - \$500M	1,102	22.86%	11.50%
<\$100M	3,000	62.24%	4.06%
Total	4,820	100.00%	100.00%



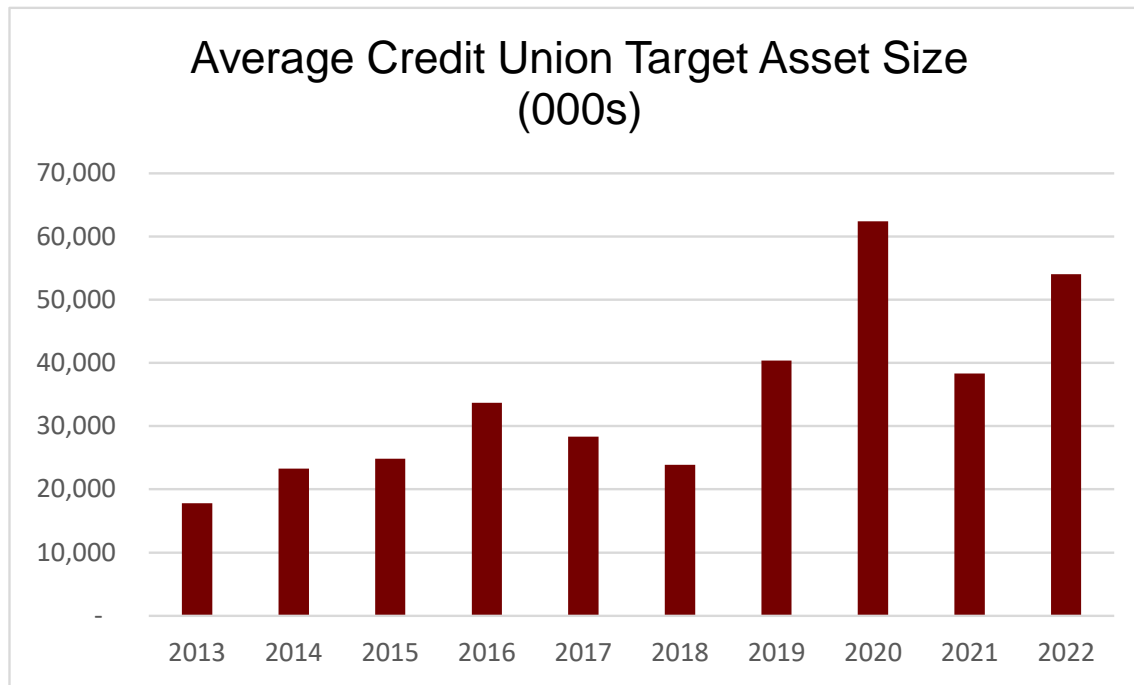
TRENDS AND ECONOMICS

Credit Union Mergers vs Number of Credit Unions



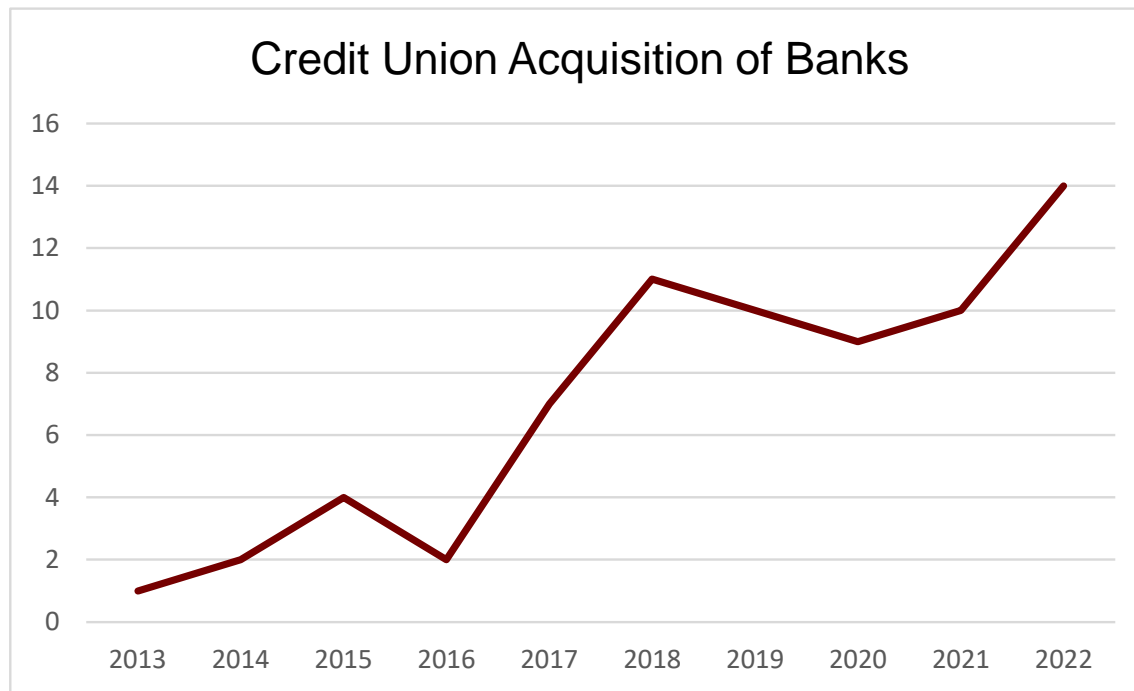
TRENDS AND ECONOMICS

Size of Credit Union Mergers



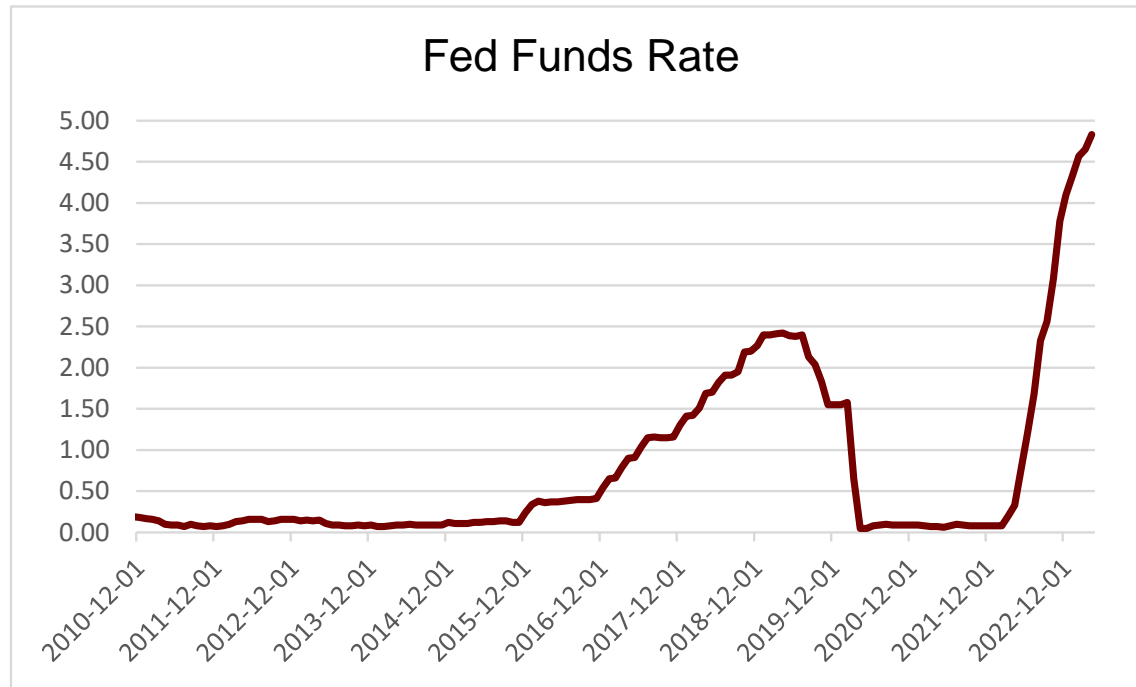
TRENDS AND ECONOMICS

Credit Union Acquisitions of Banks



TRENDS AND ECONOMICS

Interest Rates





BASICS OF PURCHASE ACCOUNTING

BASICS OF PURCHASE ACCOUNTING

Previous Requirement

- Prior to 2009
- “Pooling of Interests”
- Combine book values

New Requirement

- January 1, 2009
- “Purchase Accounting”
- Determine fair value of acquired credit union

BASICS OF PURCHASE ACCOUNTING

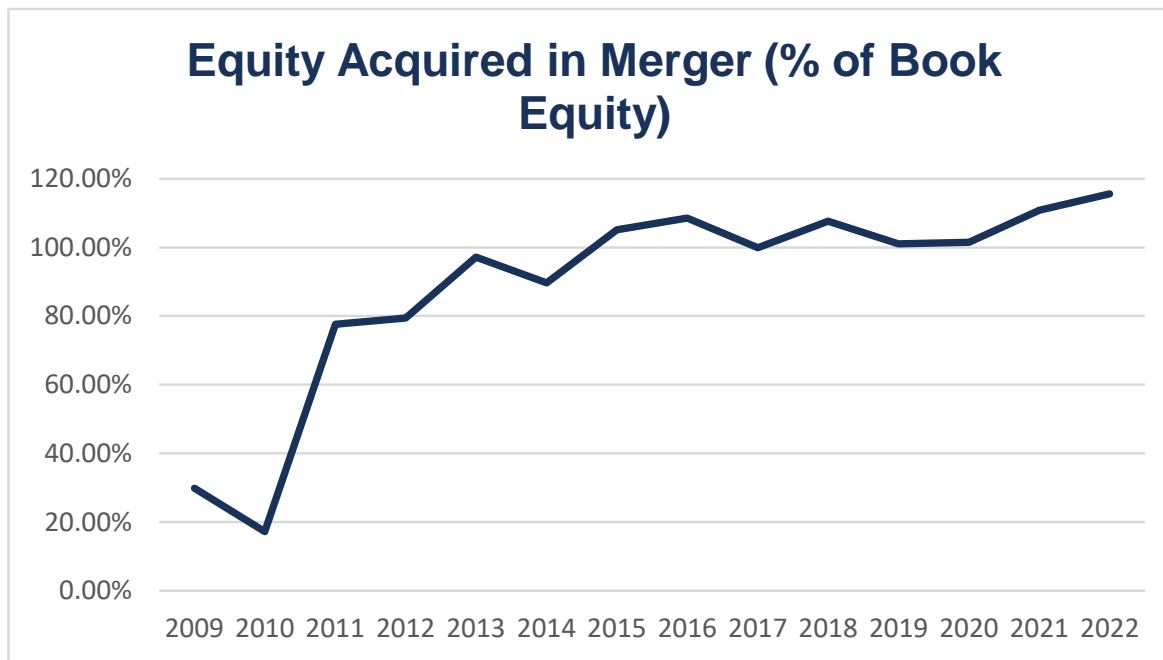
Valuation Steps

- Fair value of merging-in credit union
- Fair value of credit union's financial assets and liabilities
- Fair value of credit union's non-financial assets and liabilities
- Fair value of any intangible assets – the most common being the core deposit intangible and mortgage servicing rights
- Fair value of the trade name
- Fair value of equity and amount of goodwill/bargain purchase gain (rare)



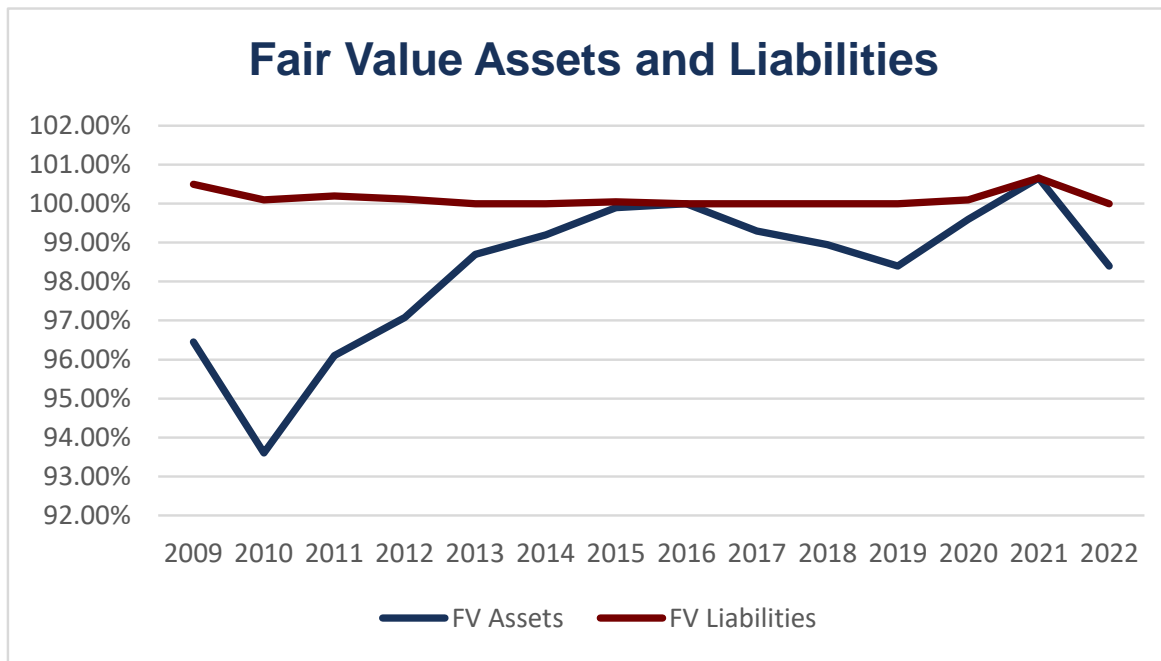
BASICS OF PURCHASE ACCOUNTING

Fair Value of Merging-In Credit Union



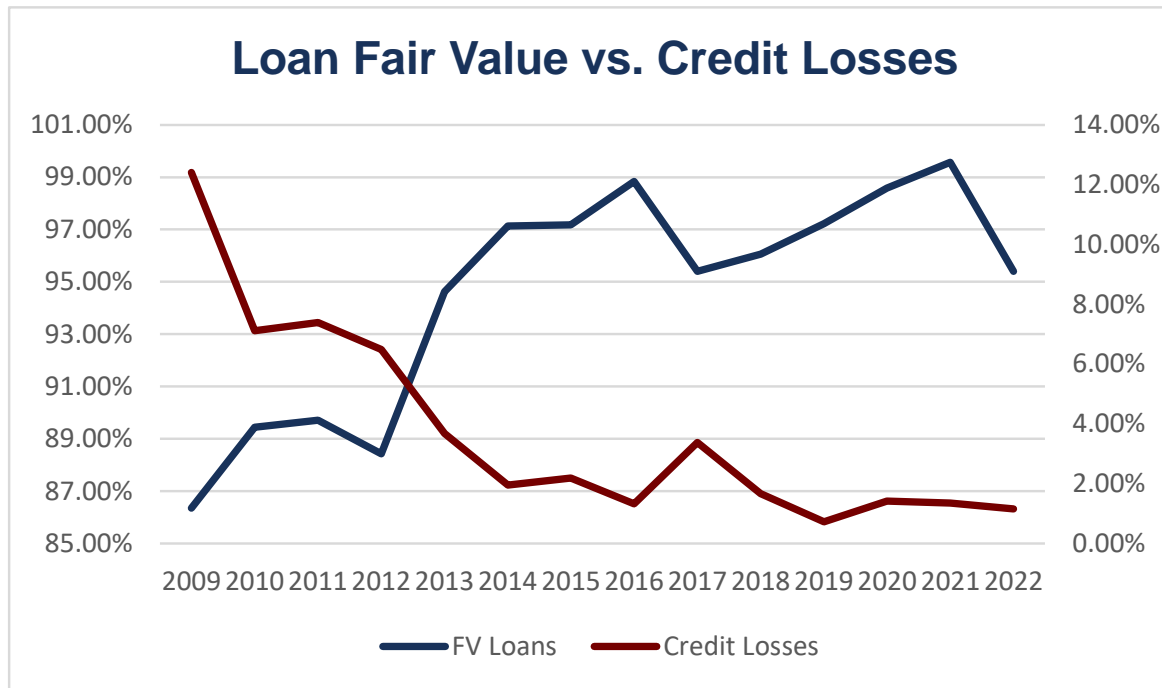
BASICS OF PURCHASE ACCOUNTING

Fair Value of Assets and Liabilities



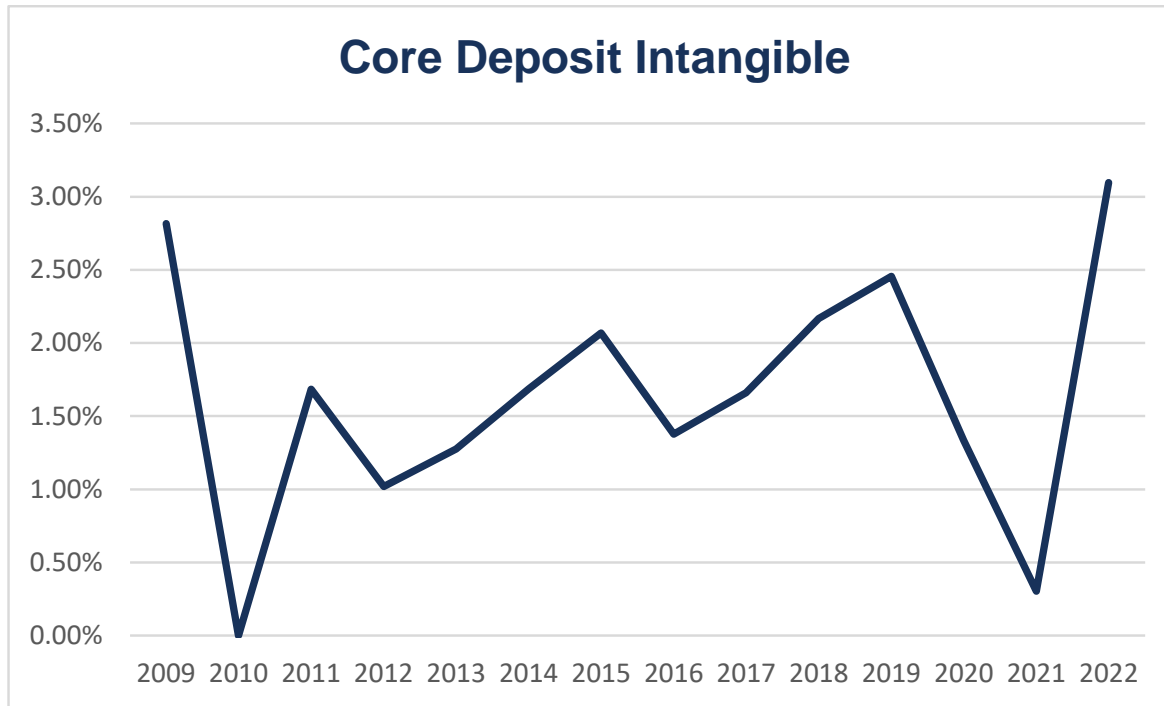
BASICS OF PURCHASE ACCOUNTING

Fair Value of Loan Portfolios



BASICS OF PURCHASE ACCOUNTING

Fair Value of Core Deposit Intangible



BASICS OF PURCHASE ACCOUNTING

Day One Accounting

Abc CU Journal Entries to Adjust Acquired's Book Value (GAAP)

	Debit	Credit	Net Summary	Future Lifetime Impact on Income
<u>Investments</u>				
Time and Other Deposits	-	1,126,115		1,126,115 Increase in Interest Income
AFS MBS	-	971,477		971,477 Increase in Interest Income
AFS MBS - Premium	-	75,551		
AFS MBS - Unrealized Loss	957,799	-	(1,215,344)	
<u>Loans</u>				
Credit Adjustment	-	875,951	(875,951)	875,951 Increase in Interest Income
Discount Rate Adjustment	-	1,586,919	(1,586,919)	1,586,919 Increase in Interest Income
Total Loans and Leases - Loss Allowance	361,071	-	361,071	
<u>Fixed Assets</u>				
Land and Building	-	2,691,199	(2,691,199)	
<u>Other Assets</u>				
Core Deposit Intangible	3,022,340	-	3,022,340	(3,022,340) Decrease in Non-Interest Income
<u>Shares</u>				
Share Certificates	39,507	-	39,507	(39,507) Increase in Interest Expense
IRA/KEOGH Certificates	1,797	-	1,797	(1,797) Increase in Interest Expense
<u>Equity</u>				
Equity (removal of existing equity accounts)	8,077,568	-		
Equity (record equity acquired in merger)	-	9,577,853	(1,500,285)	
Goodwill	4,444,983	-	4,444,983	
Bargain Purchase	-	-	-	
	16,905,065	16,905,065	0	1,496,817 Net Future Income Impact



BASICS OF PURCHASE ACCOUNTING

Day Two and Ongoing Accounting

- **Investments** – premiums or discounts are amortized or accreted as either a decrease or increase in interest income.
- **Time deposits** – premiums or discounts are amortized or accreted as either a decrease or increase in interest expense.
- The **core deposit intangible** is amortized on a level-yield over the estimated lives of the non-time deposits. The expense should be recorded as a reduction to non-interest income.
- The fair value of the **fixed assets** acquired becomes the basis for depreciation. The fixed assets should be depreciated over their estimated remaining lives, which can be longer or shorter than the term used to calculate depreciation before the acquisition.



BASICS OF PURCHASE ACCOUNTING

ASC 326-20 – Non-PCD Loans

- **Performing loans** (acquiring credit union expects to receive all contractually specified principal and interest payments) accounted for in accordance with FAS ASC 310-20.
 - Loan premium/discount should be amortized or accreted into income on a level-yield basis over the expected life of the loan.
 - An allowance for credit loss should be recorded on day one (double count effect).

ASC 310-30 – PCD Loans

- Loan is reported at purchase price (fair value).
 - At acquisition, a financial institution will estimate and record an allowance for credit loss, which is then added to the purchase price.
- Favorable and unfavorable changes in expected credit-related cash flows will run through the allowance and credit loss expense.
- Non-credit premium or discount will be accounted for based on the effective yield after the gross-up for the allowance.





ACCOUNTING IMPLICATIONS

ACCOUNTING IMPLICATIONS

Steps Taken in Successful Deals

1. Develop an acquisition strategy
2. Identify bank candidates
3. Valuation analysis
4. Negotiations/Drafting Letter of Intent
5. Due Diligence
6. Purchase agreement
7. Legal close
8. Operational close

Considerations of M&A

1. Customer impact
2. Cultural
3. Employee
4. Technology
5. Governance
6. Financial
7. **Accounting Implications**



ACCOUNTING IMPLICATIONS

Day One Capital Impact

- **GAAP Equity**

Acquirer's Equity before OCI Adjustment (ABC CU pre-merger equity)

Plus: Acquirer's OCI Adjustment

Total GAAP Equity

Plus: Equity Acquired in Merger

Plus: Bargain Purchase Gain

Acquirer's Post-Merger GAAP Equity

- **Regulatory Equity**

Acquirer's Regulatory Net Worth After Merger

Less: OCI Adjustment

Less: Equity Acquired in Merger

Plus: Adjustments to Retained Earnings through Business Combinations

Equity for PCA Net Worth Calculation



ACCOUNTING IMPLICATIONS

Goodwill

- Amount required to balance day one journal entries
- Accounting for goodwill:
 - Amortized – irrevocable accounting election
 - Annual impairment testing
 - Qualitative
 - Quantitative
- Risk – based capital



ACCOUNTING IMPLICATIONS

Ongoing Earnings Impact

- Discounts on assets are accreted as additional income
- Premiums on assets are amortized as reductions to income
- Discounts on liabilities are amortized as additional expense
- Premiums on liabilities are accreted as reductions to expense



ACCOUNTING IMPLICATIONS

Fair Value Example – 2021 Valuation – Abc CU

- Asset Size - \$200M
 - \$165M in loans
 - \$15M in investments
 - \$175M in shares
- Preliminary Results
 - Loan FV – 99.3%
 - Investments - \$145k unrealized gain
 - CDI – 0.6%
 - Fair Value of Equity – 1.35x
- Impact
 - Regulatory capital – 8.56%
 - Goodwill - \$8.0M
 - Income Impact - \$1.5M

Fair Value Example – 2022 Valuation – Abc CU

- Asset Size - \$200M
 - \$180M in loans
 - \$10M in investments
 - \$185M in shares
- Final Results
 - Loan FV – 94.3%
 - Investments - \$1M unrealized loss
 - CDI – 5.0%
 - Fair Value of Equity – 1.30x
- Impact
 - Regulatory capital – 7.63%
 - Goodwill - \$9.5M
 - Income Impact - \$5.0M



ACCOUNTING IMPLICATIONS

Fair Value Example – Abc CU

- Asset Size - \$1.1B
 - \$900M in loans
 - \$100M in investments
 - \$950M in shares
 - **95% loan to deposit ratio**
- Impact
 - Goodwill - \$55.0M
 - Income Impact - \$64.0M

Fair Value Example – Xyz CU

- Asset Size - \$1.0B
 - \$550M in loans
 - \$500M in investments
 - \$900M in shares
 - **60% loan to deposit ratio**
- Impact
 - Goodwill - \$32.0M
 - Income Impact - \$32.0M



ACCOUNTING IMPLICATIONS

Fair Value Example – Abc CU

- Asset Size - \$500M
 - \$400M in loans
 - \$50M in investments
 - \$450M in shares
 - **Large concentration in fixed rate real estate lending**
- Impact
 - Goodwill - \$10.0M
 - Income Impact - \$12.0M

Fair Value Example – Xyz CU

- Asset Size - \$500M
 - \$400M in loans
 - \$50M in investments
 - \$450M in shares
 - **Large concentration in auto lending**
- Impact
 - Goodwill - \$2.0M
 - Income Impact - \$(2.5M)





ACCOUNTING UPDATES

ACCOUNTING UPDATES

ASC 326-20 – Pre-CECL

- **Performing loans** (acquiring credit union expects to receive all contractually specified principal and interest payments) accounted for in accordance with FAS ASC 310-20.
 - Loan premium/discount should be amortized or accreted into income on a level-yield basis over the expected life of the loan.
 - Loans should be monitored periodically to determine if an allowance for loan loss should be recorded.

ASC 326-20 – CECL

- **Performing loans** (acquiring credit union expects to receive all contractually specified principal and interest payments) accounted for in accordance with FAS ASC 310-20.
 - Loan premium/discount should be amortized or accreted into income on a level-yield basis over the expected life of the loan.
 - An allowance for credit loss should be recorded on day one (double count effect).



ACCOUNTING UPDATES

ASC 310-30 – Pre-CECL

- Loan is reported at purchase price (fair value).
 - Accretible yield – amount of expected cash flows that exceed the initial investment in the loan, and is recognized as interest income on a level yield basis over the life of the loan
 - Nonaccretible difference – excess of total contractual cash flows over the cash flows expected to be received
- Acquiring institution must periodically reassess the expected cash flows of loans accounted under ASC 310-30, along with the cash flows received.
 - An increase in expected cash flows must be accounted for as an increase in the rate of accretion over the remaining life of the loan.
 - Conversely, if expected cash flows decrease, impairment should be recognized through establishing an allowance for loan losses.

ASC 310-30 – CECL

- Loan is reported at purchase price (fair value).
 - At acquisition, a financial institution will estimate and record an allowance for credit loss, which is then added to the purchase price.
- Favorable and unfavorable changes in expected credit related cash flows will run through the allowance and credit loss expense.
- Non-credit premium or discount will be accounted for based on the effective yield after the gross-up for the allowance.



ACCOUNTING UPDATES

Performing Loans Example

ASC 326-20 Accounting (Pre-CECL)	
Total Performing Loans	15,000,000
Less: Discount Rate Adjustment	(400,000)
Less: Credit Adjustment	(75,000)
Net Balance	14,525,000
ALLL %	0.0%
Allowance for Loan and Lease Losses	0
Net Balance including ALLL	14,525,000

ASC 326-20 Accounting (CECL)	
Total Performing Loans	15,000,000
Less: Discount Rate Adjustment	(400,000)
Less: Credit Adjustment	(75,000)
Net Balance	14,525,000
ACL %	0.5%
Allowance for Credit Losses	(72,625)
Net Balance including ACL	14,452,375

Double counting of the credit adjustment under CECL results in an allowance for credit losses provision on Day 1



ACCOUNTING UPDATES

PCI vs PCD Example

ASC 310-30 PCI Accounting (Pre-CECL)	
Total PCI Loans	1,500,000
Less: Discount Rate Adjustment	(50,000)
Less: Credit Adjustment	(300,000)
Net Balance	1,150,000
ALLL %	0.0%
Allowance for Loan and Lease Losses	0
Net Balance including ALLL	1,150,000

ASC 310-30 PCD Accounting (CECL)	
Total PCD Loans	1,500,000
Less: Discount Rate Adjustment	(50,000)
Less: Credit Adjustment	(300,000)
Plus: Allowance for Credit Losses	300,000
Net Balance	1,450,000
ACL %	20.0%
Allowance for Credit Losses	(300,000)
Net Balance including ACL	1,150,000

Results are the same based on the credit adjustment



ACCOUNTING UPDATES

Pending Guidance

- FASB decided at its February 2, 2022, meeting to amend the accounting for acquired assets to eliminate the distinction between purchased credit deteriorated (PCD) and non-PCD assets.
 - PCD accounting model will apply for acquired assets, with certain exceptions, which includes asset acquired in a business combination.
- FASB directed the Board to draft this updated rule at its March 31, 2023, meeting.

TAKEAWAYS

1. Changes in interest rates have a large impact on valuation results for purchase accounting.
2. The heightened rate environment has resulted in devaluation of interest-bearing assets, whereas core deposit intangibles are at historically high levels.
3. Purchase accounting can have positive or negative impacts to the combined institution's capital and ongoing earnings.
4. Balance sheet mix plays a large role in determining capital, goodwill, and ongoing earnings impacts.
5. Pending guidance from FASB would greatly simplify the ongoing treatment of loan discounts.



CONTACT US

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FAIR VALUE RESOURCES

Website

Resources

Financial accounting and regulatory reporting continue to grow increasingly complex. Find jargon-free answers to your questions here.

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ABOUT WILARY WINN

- Founded in 2003, Wilary Winn provides expert, unbiased, fee-based, actionable advice to banks and credit unions. We have more than 600 financial institution clients in 49 states, including 45 of the top 100 credit unions.
- Our mission is to strengthen community financial institutions because we believe they are key to healthy communities.
- We use state-of-the art technology to ensure our work is completed timely and cost-effectively. Our technology providers include: Bloomberg, S&P Global Market Intelligence, Intex, Black Book, and ZM Financial Systems Inc.



A blue-tinted photograph of two men in business suits. The man on the left is leaning over the man on the right, who is seated and looking at a document. They appear to be in a professional setting, possibly a meeting or a review session. The background is slightly blurred, showing what might be a desk or office equipment.

Thank You

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