WILARY WINN LLC

Significant Improvements to Accounting for Acquired Assets

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On February 2, 2022, the FASB Board decided to generally apply purchased credit deteriorated (PCD)[1] accounting to assets obtained in mergers and acquisitions. PCD accounting is applicable to institutions which have adopted CECL. In making the change, FASB eliminated the distinction between PCD and non-PCD assets. There are certain exceptions to the rule, including loans with revolving provisions, such as credit cards. In addition, the assets acquired must be "seasoned" to qualify the revised accounting.

> **The changes are not yet finalized, but the board's directives to FASB staff regarding next steps are related to implementation, including defining seasoned. At first glance, this might seem to be just another technical update. However, these changes are very significant.**

Under the rules for mergers and acquisitions, an acquirer first eliminates the acquired institution's existing allowance for loan and lease losses. For non-PCD assets, any purchase discount, whether related to interest rate or expected credit loss, is recognized over the expected life of the loan as interest income on a level yield basis. The acquirer must also establish a new allowance for loan and lease losses, which flows through the combined entity's income statement on day one based on the full amount of the loan. The result is peculiar and is generally referred to in the industry as double counting the expected credit loss. Consider this highly simplified example. ABC institution acquires a non-PCD loan for 97. The acquirer valued the loan based on an interest rate discount of 2 and an expected credit loss of 1. Under the required accounting, it records a 3-point interest rate discount and a loan loss provision for 1 point based on the full amount of the loan. Subsequent cash flows come in as expected and it accretes the loan up to 100 and has an ACL of 1 at the end of year 3 when the loan pays off at 99. It thus recorded 1 point more of interest income over the 3 years than it expected to collect on day one and recognized a day one credit loss.

On the other hand, purchase discounts for PCD assets can be divided into an interest rate component and a credit component. The interest rate portion is allocated to each asset acquired and recognized on a level yield basis over the expected life of the loan. The expected credit losses are not accreted into interest income as in the examples above. Instead, they are added to the asset's purchase price with the offset recorded to the new ACL. This avoids the overstatement of interest income and credit loss in the non-PCD loan examples. This more favorable accounting treatment incented acquirers to use PCD accounting for as many assets as they could.

> **The change in accounting means that the portion of the discount related to expected credit losses on assets which would have been considered non-PCD assets, can be recorded as an increase to basis with a corresponding ACL.**

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[1] PCD assets are defined under CECL as those which have experienced a more than insignificant deterioration in credit quality since inception.

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In addition, at the February 2, 2022, meeting, FASB decided the new PCD accounting can be used for purchases of assets unrelated to business combinations. Thus, purchases of seasoned loans will qualify for the updated accounting.

Wilary Winn will continue to monitor these changes, as they are quite beneficial to acquirers.

We note that our discounted cash flow models have always separated the discount related to interest rate from those related to credit, greatly facilitating our clients' ability to use the new and improved accounting.