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Credit Union Merger Accounting Guidance

Following are some of the most frequently asked questions related to merger accounting that we have encountered over the most recent several years. We note that the questions and answers which follow are not meant to be definitive and strongly encourage readers to consult our full white paper on the subject before developing proposed accounting policies and practices.

How do the new accounting rules differ from the old rules?

Accounting for mergers under the old rules was relatively straightforward. To form the combined entity, the book values of the acquiring and acquired credit unions were added together. Beginning in January 2009, this “pooling of interests” accounting was replaced with the more complex “purchase accounting”. Under the purchase accounting rules, the acquired credit union and its assets and liabilities must be recorded at their estimated fair values. WW Risk Management notes that the fair value determination applies to the acquired credit union only.

I hear credit union combinations referred to in various ways. What do these terms mean?

When two credit unions elect to voluntarily merge, the surviving credit union is referred to as the *continuing* or *acquiring* credit union. The credit union that will be merged into the surviving credit union is referred to as the *dissolving, merging, or acquired* credit union.

A credit union can enter into an agreement to purchase branches from another credit union. In this case the credit union is *acquiring* loans and *assuming* liabilities. This transaction can be considered as the acquisition of “*business*” under the new rules. In this case, the value of the branches as a separate business entity needs to be performed.

Another term that sounds similar is a “*purchase and assumption agreement*”. This is an agreement that runs between the NCUA and an acquiring credit union that details the assets the credit union agrees to purchase and the liabilities it is willing to assume. It also specifically identifies the assets and liabilities the NCUA will retain. The agreement is used when the NCUA is serving its role as liquidating agent for a credit union that has failed.

Purchase accounting refers to the fair value estimates that must be made under the new rules.

Why were the new rules put into place?

The new rules were a result of the effort to converge the U.S. accounting rules for fair value with the international standards.

How does it help credit unions?

The new rules were not written to be specifically applicable to credit unions. They were written for business combinations in general and credit unions are affected the same as other entities.

Is there a size minimum for the new regulations?

The new accounting rules do not make an exception based on the size of the transaction. However, WW Risk Management believes that the adoption of the rules should be based on common sense and that the benefit of a full third party valuation may not exceed the cost for transactions that are clearly immaterial to the acquirer.

Are credit unions allowed to determine the value of the target themselves?

WW Risk Management believes that the management of the acquiring credit union is responsible for its financial statements and that an organization could undertake the valuation on its own. However, in our experience, this is rarely done because of the complexity of the calculations.

What is the difference between a merger versus acquisition of assets and assumption of liabilities?

Under a merger, the acquirer purchases all of the assets and assumes all of the liabilities of the acquired credit union. In some cases, the acquirer may not be willing to purchase certain assets, assume certain liabilities, or be willing to take the risk of incurring unknown liabilities. In these situations, the parties agree on the specific assets to be acquired and liabilities to be assumed. Regardless of whether the transaction is a merger, or an acquisition and assumption agreement, the assets acquired and liabilities assumed must be recorded at fair value. This includes unrecorded intangible assets – the most common being the “core deposit intangible”. In a merger, the acquirer must also determine the value of the “business” – the value of the credit union as a standalone entity. The acquisition of assets and assumption of liabilities can also be considered to be the acquisition of a “business”. In this situation, the acquirer also has to determine the fair value of the business based on marketplace assumptions. An acquisition of a branch is an example.

What role does the NCUA play in the merger or acquisition?

The NCUA can undertake various roles in combinations of credit unions. In the case of a voluntary merger, the NCUA must approve the transaction and wants to know the net worth ratio of the combined entity after the merger as part of its approval process. In some cases, the NCUA will facilitate a bidding process for a troubled institution. In other cases, the NCUA will seize an institution and then enter into agreements under which a credit union will purchase certain assets and assume liabilities from the NCUA in its role as liquidating agent. WW Risk Management believes that while a purchase and assumption transaction can be construed as the acquisition of a business, we also believe that the value of the overall entity will generally be zero.

What is the difference between an assisted or un-assisted transaction?

In certain cases, the NCUA will offer cash and/or agree to indemnify the acquirer for liabilities in order induce a purchaser to enter into a transaction that it otherwise would be unwilling to do. This would be an assisted transaction. For example, an acquirer may want assistance if the fair value of the liabilities to be assumed is well in excess of the fair value of the assets to be acquired. An unassisted transaction does not include financial help from the NCUA.

When should a credit union ask for assistance?

A credit union should consider asking for assistance if it believes the difference between the liabilities to be assumed and the assets to be acquired is greater than the strategic benefit of the acquisition. The strategic benefit can be “offensive” – to grow in an existing market or enter into a new market. The benefit can also be defensive – to prevent a formidable

competitor from entering into its marketplace. The request is a calculated risk, as a competitor may be willing to undertake the transaction without assistance.

Is the assistance treated as capital?

No, the assistance provided is recorded at its fair value as of the transaction date. If the liabilities assumed exceed the fair value of the assets received, including the assistance, the difference is goodwill. On the other hand, if the fair value of the assets acquired and consideration received exceed the fair value of the liabilities assumed, the difference is a “bargain purchase”. The gain arising from a bargain purchase flows through the income statement.

If the merger is un-assisted, does the acquiring credit union have to purchase all of the assets and acquire all of the liabilities?

No, the acquiring credit union can exclude certain assets and liabilities from its bid without also asking for cash assistance or indemnification. For example, an acquirer may not want to purchase a building that is located near to one of its existing branches.

How does the bid process work? Will the NCUA just pick the credit union with the lowest bid?

WW Risk Management believes that the NCUA has an obligation to minimize costs to the insurance fund. That said, we also recognize that the NCUA will also consider the needs of the acquired credit union’s members.

What valuation needs to be done in order to obtain NCUA approval for the transaction?

WW Risk Management believes that high level estimates can be used in the approval application to the NCUA. We believe that the acquiring credit union should perform a detailed valuation as of the acquisition date in order to properly record the day one journal entry.

What are the differences between merging in a full credit union versus acquiring some of the branches? Do the purchase accounting rules still apply?

Regardless of whether the transaction is a merger, or a branch acquisition, the assets acquired and liabilities assumed must be recorded at fair value. In a merger, the acquirer must also determine the value of the “business” – the value of the credit union as a standalone entity. The acquisition of a branch can also be considered to be the acquisition of a “business”. In

this situation, the acquirer again has to determine the fair value of the business based on marketplace assumptions.

How is the value of the entity determined?

The value of the entity is generally determined through an income approach and market value approaches. Under the income approach, the acquired credit union's future earnings are discounted back to the valuation date at an appropriate discount rate. The discount rate is often developed using a Capital Asset Pricing Model (CAPM).

How are market transactions used to determine the value of the entity?

Business appraisers will generate market comparables by analyzing publicly traded financial institutions of similar size, in similar markets, with similar strategies using Market Value approach. In addition, appraisers will look at the deal results for similar mergers and acquisitions in the marketplace – the Guideline Transaction approach. The market prices are adjusted based on the acquired credit union's growth and performance.

Is entity valuation subject to a floor?

Regardless of the income and market valuation results, the fair value of the assets and liabilities – essentially the liquidation value of the acquired credit union serves as the floor price for the transaction.

How will the transaction affect the balance sheet for GAAP vs regulatory reporting?

Congress and the NCUA were worried that the new purchase accounting rules could discourage mergers. As a result, the regulatory capital of the combined entity is based on the retained earnings of the acquired entity versus its estimated fair value. For example, assume that the fair value of the acquired credit union is 50% of its book value of \$10 or \$5. For the purpose of calculating regulatory capital, the acquiring credit union would use the \$10 instead of the \$5. WW Risk Management notes that this adjustment causes the regulatory net worth to be similar to the results under the prior pooling of interests method.

How is the core deposit intangible calculated?

The premise underlying the core deposit intangible is that a rational buyer is willing to pay a premium to obtain a group of core deposit accounts that are less expensive than the buyer's marginal cost of funds. The value is determined through a discounted cash flow analysis. WW Risk Management believes the core deposit intangible depends on the type of account. For example, share drafts accounts have very different economics and behavior than high rate money market shares. To calculate the estimated fair value of the core deposit intangible, we

first segment the accounts by type. Next, we estimate the likely run-off, average life and terminal economic life. We calculate the intangible value by considering the economic life, the rate paid on the deposit, the non-interest income generated, and the non-interest expense incurred by account compared to an alternative cost of funds.

Why do banks appear to be willing to pay more for core deposits than do credit unions?

We note that banks, while similar to credit unions, have distinct differences in the benefits realized from holding core deposits. Credit unions typically pay higher rates on deposits, as their strategy is to maximize the benefits members receive. This directly increases the cost of holding deposits and decreases the value of the core deposit intangible. We also note that banks believe they can execute a more comprehensive cross-selling strategy that will generate more fees from customers. Therefore, we believe banks are willing to pay a higher premium for core deposits.

How is the goodwill calculated? How is this different than under the Pooling of Interests methodology?

Under the purchase accounting rules, the value of the goodwill is the “plug” or the difference between the fair values of the assets and the liabilities recorded on the acquisition date. The accounting rules presume that goodwill will be recorded on “day one”. The rules contemplate the recording of a bargain purchase when the fair value of the assets recorded exceeds the liabilities assumed. However, bargain purchases are intended to be relatively rare events. In fact, the rules require that an acquirer “double check” its work before recording a bargain purchase.

Conversely, under the pooling of interests method, the journal entry on day one balanced – total assets equaled liabilities plus net worth and no “plug” was required.

What happens to the goodwill going forward? Is it amortized?

A credit union can make an irrevocable to amortize the goodwill over a period not to exceed 10 years. We caution that the decision applies to the existing goodwill and all future goodwill incurred.

If the credit union does not make this election, the goodwill is subject to impairment testing at least annually.

Can the goodwill be impaired on Day 1? How?

Yes, if the “plug amount” recorded on day one appears to be “excessive” relative to the intangible benefits of the members acquired, the goodwill could be deemed to be impaired on day one. This is obviously complex and based on judgment.

What is the benefit of having a bargain purchase? When would a bargain purchase arise?

WW believes that the recording of a bargain purchase is a relatively rare event and there would have to be a unique set of circumstances. As the overall value of the entity has a floor value of the liquidation amount of its assets and liabilities, an entity would have to have a non-separable intangible asset, such as value in the trade name, which would not be taken into account in a liquidation event. We have also seen bargain purchases arise in NCUA-assisted or bid transactions, where the value of the net assets received, including the consideration from the NCUA, is greater than the amount of liabilities assumed.

Is the bargain purchase amount ever tested for impairment?

No, the bargain purchase is not tested for ongoing impairment.

Can I expense or accrue merger related expenses on the acquired credit union’s books prior to the merger? What costs can be accrued as part of the merger?

No, in general, the costs of the merger and any restructuring costs should flow through the income statement of the acquiring credit union. The theory is that if the party that receives the primary benefit is the buyer or the combined entity, the cost should run through its income statement. In our experience, the types of costs that can be accrued as part of the merger are quite limited. An example would be a compensation arrangement that was in place before the merger was contemplated, and that just happens to be triggered as a result of the merger. The required payout can be accrued on the acquired credit union’s books as of the merger date. By way of contrast, a payout negotiated as part of the merger should run through the income statement of the acquiring credit union.

Why is a land and building appraisal needed as of the merger date? Can the tax assessed values be used instead?

WW Risk Management believes that a full commercial real estate appraisal is the best indicator of fair value. We note that our clients have successfully used broker price opinions or tax assessed values in cases where the amounts are not material to the overall transaction.

Should the acquired credit union's allowance for loan losses be increased prior to the merger? Why not?

WW Risk Management notes that under the pooling of interests methodology, the acquiring credit union often encouraged the acquired credit union to boost its allowance prior the merger in order to minimize the chances of incurring additional provision expense for the acquired loans on the combined entity's financial statements. We recommend that this tactic not be used under the new rules because the allowance is brought over to the combined entity's financial statements at zero. We recommend this because the acquiring credit union is able to use the acquiring credit's equity before any fair value adjustments for purposes of calculating the regulatory capital ratio for the combined entity. Padding the loan loss provision lowers the potential benefit of this "step-up".

On the other hand, in our experience, as part of their analysis of the merger transaction, the external auditors and the NCUA will review the allowance for loan losses to ensure it is not underfunded at the merger date.

What type of fair value adjustments can I expect?

The fair value adjustments relate primarily to interest rate differential and credit risk. The interest rate differential is calculated by comparing the interest rate on an investment or loan to market interest rates. If market interest rates are higher, then a discount must be recorded. If market rates are lower, then a premium must be recorded. The opposite is true in both cases for time share accounts.

WW Risk Management notes that the fair value of the loans will include a reduction for expected credit losses. The allowance for loan and lease losses is therefore zero on day one.

How do I record the fair value adjustments?

The adjustments should be recorded as "contra-asset" or "contra-liability" accounts. The contra accounts are then amortized or accreted into income or expense. The simplest example is the recording of a purchase discount on a bond.

What entries do I make on day 1 – the actual merger date and what are the entries required on day 2 and beyond – the ongoing accounting?

On the effective date of the merger, the acquiring credit should record all the assets acquired and all the liabilities assumed at book value and then should record the fair value adjustments for the amount that is the difference between the book value and the fair value. In most cases, new accounts for these fair value adjustments should be created and below is a listing:

HTM Investments: Fair Value Adjustment – Investments (contra-asset)

Loans: Fair Value Adjustment – Loans – Credit Valuation Allowance (contra-asset)
Fair Value Adjustment – Loans – Discount Rate Allowance (contra-asset)

Fixed Assets: No new account is needed; FV adjustment can be made to original account

Land and Bldg: No new account is needed; FV adjustment can be made to original account

FC & Repo: No new account is needed; FV adjustment can be made to original account

CDI: Fair Value Adjustment – Core Deposit Intangible (asset)

Certificates: Fair Value Adjustment – Certificates (contra-liability)

The acquiring credit union also records the overall equity value of the acquired credit union – the value of the “business”. In addition to the fair value adjustments above, the value of the loan loss reserve should be zeroed out. The acquired credit union then records goodwill (usually) or a bargain purchase (rarely) to balance the journal entry.

On day 2 and beyond, in addition to the usual day to day accounting, the acquiring credit union accretes and amortizes premiums and discounts adjusting interest income and expense as shown below:

Investments: The amortization of a FV premium will reduce interest income and the accretion of a discount will increase interest income

Loans: Charge-offs and recoveries are booked to the Loans – Credit Valuation Allowance (instead of Allowance for Loan Losses)
The accretion of a FV discount will increase interest income and the amortization of a premium will reduce interest income

Fixed Assets: The fair value amount should be amortized over the remaining life

Land and Bldg: The fair value amount should be amortized over the remaining life

CDI: The amortization of a FV premium will reduce non-interest income

Share Certificates: The accretion of a FV premium will reduce interest expense and the amortization of discount will increase interest expense

We note that the equity acquired in merger amount will not change going forward. The goodwill amount is either amortized or tested for impairment on an annual basis.

How will the transaction impact the income statement going forward?

The discounts on loans and investments are accreted as additional interest income. Premiums on loans and investments are amortized as reductions to interest income. Premiums on liabilities are accreted as reductions to interest expense and discounts are amortized as increases to interest expense. Goodwill can be amortized over a period not to exceed 10 years provided the credit union makes this irrevocable election.

What lives are used to amortize or accrete the fair value adjustments?

The accretion or amortization should be done on the “level yield method”. To facilitate our client’s accounting, WW Risk Management first calculates the level yield accretion/amortization based on expected cash flows. We then build a monthly accretion/amortization table using the sum of the years' digits method that closely matches the level yield results. Our clients record these accretion/amortization amounts monthly versus having us go through the costly process of recalculating the level yield monthly as cash flows are received.

What fair value adjustments are not amortized or accreted?

The only fair value adjustment that is not generally not accreted or amortized is goodwill. It is subject to at least annual impairment testing (unless the credit union makes an irrevocable election to amortize it).

Do I have to account for the contra-accounts at the loan level?

No, you can elect to account for the acquired loans at the group level. We recommend that the acquiring credit union account for loans that have immaterial credit valuation allowances at the loan level. We recommend that the discount rate valuation allowance and the credit valuation allowance be combined and amortized over the expected remaining life of the loan.

We recommend that all of the remaining loans except relatively large member business loans be accounted for at the group level because they will fall under ASC 310-30 (formerly SOP 03-3). (See below for more information on member business loans). This means that the interest income will be recorded on estimated cash flows rather than contractual cash flows. Interest income is recorded based on a prospective yield. As a practical matter, this entails amortizing the interest rate discount valuation allowance into interest income and reviewing actual losses incurred to determine if they are consistent with the credit loss valuation estimate. This calculation is much simpler at the group level.

WW Risk Management recommends that the acquiring credit union charge actual foreclosure losses to the credit valuation allowance. In our experience, the NCUA prefers to see losses run through the allowance for loan losses and related provision accounts. WW Risk Management therefore recommends that foreclosure losses be recorded through the three following journal entries. In our example, we assume a foreclosure loss of \$100.

Allowance for loan losses	100	
Loan receivable		100
Provision for loan losses	100	
Allowance for loan losses		100
Credit reserve valuation allowance	100	
Other non-interest income		100

The net effect of these entries with regard to profit and loss is zero. However, the actual foreclosure losses incurred are easier to track because they run through the standard accounts. We note that the final credit should run through other non-interest income, not interest income, because the entry is designed to offset the provision expense and is not meant to reflect an adjustment to the prospective yield.

We further recommend that the acquiring credit union allocate the carrying amount of the foreclosed loan based on the individual loan's relative initial fair value. This method mirrors traditional loan accounting and is consistent with the requirements of ASC 310-30. Under this method, a gain or loss would be recognized for the difference between the allocated carrying amount of the loan and the fair value of the collateral obtained in foreclosure. When allocating costs while removing loans from the pool, the accounting principle that should be adhered to is that the yield on the remaining pool should not be disturbed by the removal. That is, the yield on the remaining pool of loans should neither increase nor decrease as a direct result of removing a loan from the pool.

Finally, if the actual cash flows for the loan group differ significantly from the cash flows expected at inception, WW recommends that the steps in the Day One valuation be repeated at the new assessment date and that new rates of accretion be calculated or that the allowance for loan losses be increased or decreased depending on whether the new cash flows have increased or decreased.

Are there special rules relating to accounting for loans at the group level?

Yes, loans cannot be removed from the group except when the loan is sold or written off. A loan cannot be removed from the original pool even if the acquiring credit union refinances the loan; the integrity of the original pool must be maintained. Additionally, loans with open lines of credits cannot be accounted for at the group level under ASC 310-30. WW Risk Management also notes that loans included within a pool at acquisition are not subject to the accounting rules for troubled debt restructurings. The effects of the TDR are included in the calculation of the prospective yield.

How should I account for member business loans that have deteriorated credit quality?

We recommend that the acquiring credit union account for relatively large member business loans at the loan level and in accordance with a strict interpretation of the accounting set forth in FAS ASC 310-30. For more on how to perform this accounting, see our white paper - *FAS 310-30 Loan Accounting*.

How are credit cards, HELOCs, and other LOCs handled on the acquirer's balance sheet? Does the FV adjustment cover the new draws? Or should the new draws be set up as new loans on the acquirer's balance sheet, and thus, these loans would run through the acquirer's normal ALLL?

Revolving loans cannot be accounted for under ASC 310-30 because of the uncertainty regarding future draws and repayments. As a result, in our experience the discount rate valuation allowance and the credit valuation allowance are amortized on a straight line basis over the remaining term of the loan. If it becomes apparent over time that the present value of the cash flows are less than the book value of the loan, then the acquiring credit union should increase its allowance for loan losses by the amount of the shortfall.

Should the delinquent loans be reported on the 5300 at the UPB amount or net of impairment reserve?

Delinquent loans should be reported net of the contra-asset accounts and not at the contractual balance due.

Why do the credit unions have 1 year to true-up the initial entries booked? When would they make adjustments?

An acquiring credit union may not have obtained all of the information needed to determine fair value by the acquisition date. The accounting rules allow the amounts initially recorded to be adjusted for up to one year following the acquisition date to reflect new information obtained that if known would have affected the fair value measurements of the acquisition

date. An example would be discovering fraud in an indirect auto loan portfolio. Any adjustments are to be made retrospectively back to the acquisition date.

Do all the assets and liabilities of the target credit union need to be tracked separately going forward until the end of their lives?

No. However, WW Risk Management believes that if the acquiring credit union elects to account for loans with impaired credit quality at the group level, the integrity of the group must be maintained and that these loans should be tracked separately. Loans should be removed from the group only through foreclosure, write-off or sale.

How is the goodwill tested for impairment?

As we indicated earlier, the goodwill recorded in a merger transaction can be amortized or the carrying amount can remain on the balance sheet subject to annual impairment testing.

If a credit union elects to amortize the goodwill, the amount can be amortized over a period not to exceed 10 years. *WW Risk Management cautions that in order to use this method, the credit union must make an irrevocable accounting election. The election affects the existing goodwill as well as any additional goodwill incurred in the future.*

If the credit union does not make the election to amortize the goodwill, it is subject to annual impairment testing. The process begins by determining the entity to be assessed. Perhaps counter-intuitively, the goodwill test is nearly always performed at the combined entity level instead of at the level of the acquired credit union. The test would be performed at the acquired credit union level only if it were deemed to be a separate operating segment or a component of a separate operating segment. WW Risk Management believes it would be rare for an acquired credit union to be considered to be a separate operating segment. This implies that the branches of the acquired credit union would have separate pricing, separate asset liability management, etc. We further believe that over time members will migrate from the acquired credit union's branches to the acquiring credit union's branches and vice versa, further clouding the distinction.

The assessment for goodwill impairment can be qualitative or it can be quantitative.

Qualitative Testing

A credit union may assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of the reporting unit is less

than its carrying amount, including goodwill. In evaluating performing the qualitative test the guidance requires an entity to assess relevant events and circumstances. Examples of such events and circumstances include the following:

- *Macroeconomic conditions* such as deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets.
- *Industry and market considerations* such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline (both absolute and relative to its peers) in market-dependent multiples or metrics, a change in the market for an entity's products or services, or a regulatory or political development.
- *Cost factors* such as increases in raw materials, labor, or other costs that have a negative effect on earnings.
- *Overall financial performance* such as negative or declining cash flows or a decline in actual or planned revenue or earnings.
- *Other relevant entity-specific events* such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation.
- *Events affecting a reporting unit* such as a change in the carrying amount of its net assets, a more-likely-than-not expectation of selling or disposing all, or a portion of, a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.

Quantitative Testing

If after assessing the totality of events or circumstances described in the paragraphs above a credit union determines that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, then the credit union must perform the first step of the two-step goodwill impairment test.

Step One is to determine whether the fair value of the combined entity exceeds its book value using the income and market approaches described at the beginning of this white paper. If the

fair value of the combined entity exceeds the book value, the goodwill is not impaired¹. If the combined entity fails Step One, it means the credit union must measure the impairment loss in accordance with Step Two.

In Step Two the credit union compares the carrying amount of the reporting unit goodwill to the implied fair value of that goodwill, and recognize an impairment loss equal to that excess. The loss recognized cannot exceed the carrying amount of goodwill.

Can the credit union perform its own goodwill impairment testing?

A credit union can perform its own impairment testing if it believes it possesses the requisite expertise.

¹ FAS ASC 350-20-35-4