WILARY WINN LLC

ADVICE TO STRENGTHEN FINANCIAL INSTITUTIONS

Accounting for Goodwill Impairment for Credit Unions

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Credit unions have been required since January 1, 2009 to account for mergers in accordance with the requirements of purchase accounting and record the transactions at fair value. This requires the determination of the fair value of the credit union to be merged in ("acquired credit union") and of all of its assets and liabilities. The valuation must also include potential intangible assets such as the core deposit intangible. Goodwill can arise from the merger date fair value determination. A credit union can then elect to amortize the goodwill or it can periodically test the goodwill for impairment.

We begin by describing how goodwill can arise through a merger transaction. Next, we describe the how to amortize or test the goodwill for impairment. We then describe FASB's recent simplification of the goodwill impairment assessment model which was issued in January 2017. The revision eliminated the comprehensive Step Two Quantitative test. Finally, we discuss how goodwill will be treated for risk-based capital purposes beginning in 2019.

Goodwill Background

The acquiring credit union must record the fair value of the acquired credit union on the date of the merger. The fair value of the acquired institution is based on the determination of:

- Overall value of the acquired credit union;
- Fair value of the acquired credit union's financial assets and liabilities;
- Fair value of the acquired credit unions non-financial assets and liabilities; and
- Fair value of any intangible assets – the most common being the core deposit intangible.
- Value of the Tradename
- Amount of Goodwill/Bargain Purchase Gain resulting from the transaction.

Goodwill arises when the overall value of the acquired credit union in total is greater than the fair value of its assets, liabilities, and intangible assets. In other words, goodwill arises when the overall value of the credit union in total is greater than the sum of its parts. We note a bargain purchase can also result through a business combination. However, this whitepaper focuses specifically on goodwill as we believe a merger transaction will generally result in goodwill, as opposed to a bargain purchase gain. In fact, GAAP requires the acquiring credit union to "double check" its work before

recording a bargain purchase.[1] Please refer to our whitepaper *Accounting for Credit Union Mergers,* for an in-depth review of the fair value determination process of an acquired credit union.

The resulting goodwill can be amortized or remain on the balance sheet at recorded value subject to annual impairment testing. These two methods are described in detail in the next section of this paper.

Accounting for Goodwill

As we noted the acquiring credit union can elect to amortize the goodwill over a period of time not to exceed 10 years.

> **Wilary Winn cautions that once a credit union has made the election to amortize the goodwill, it cannot reverse its decision. The election affects the existing goodwill, as well as any additional goodwill acquired in the future.[2]**

If the acquiring credit union does not elect to amortize the goodwill, it is required to test for goodwill impairment at least annually. 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. An entity must have all of the following characteristics to be deemed a separate operating segment[3]:

- It engages in business activities from which it may earn revenue and incur expenses;
- Its *discrete financial information* is available; and
- Its operating results are *regularly reviewed* by the chief operating decision maker ("CODM") to make decisions about *resources to be allocated* to the segment and assess its performance.

Wilary Winn 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 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

[1] FAS ASC 805-30-25-4
[2] FAS ASC 350-20-35-62
[3] FAS ASC 280-10-50-1

entity to assess relevant events and circumstances. Examples of such events and circumstances including the following[4]:

- *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.

Wilary Winn believes a qualitative test can be used if:

- The acquiring credit union meets all of the qualitative factors and passed a previous Step One quantitative test with a substantial cushion; or

- The acquiring credit union so clearly meets the qualitative factors that it is obvious it would pass Step One[5].

If the acquiring credit union has not passed a previous quantitative test by a reasonable margin or does not clearly meet all of the qualitative factors, Wilary Winn believes it should perform a quantitative test.

[4] FAS ASC 350-20-35-3C
[5] FAS ASC 350-20-35-3D

QUANTITATIVE TESTING

If after assessing the totality of events or circumstances described in the paragraphs above, the acquiring 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 income and market-based approaches consistent with the initial merger valuation. See *Wilary Winn's Purchase Accounting White Paper December 2016* for more detail on these valuation approaches. If the fair value of the combined entity exceeds the book value, the goodwill is not impaired[6]. If the acquiring credit union fails Step One it must measure the impairment loss in accordance with Step Two.

As we stated previously, FASB recently allowed entities to forgo the rigorous Step Two quantitative testing which involved marking the entire balance sheet to fair value to assess impairment. Credit unions can instead base the impairment charge on any excess between the carrying amount of the reporting unit goodwill and the implied fair value of that goodwill determined in Step One. The loss recognized cannot exceed the carrying amount of goodwill[7]. The final guidance will have an implementation date for credit unions whose fiscal years begin after December 15, 2020. Early adoption of the standard is allowed for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017.

FASB's main objective in revising the goodwill impairment model was to reduce the cost and complexity of testing for goodwill impairment. The previous Step Two required a full fair value determination of all the assets and liabilities of the entity, similar to performing a detailed merger valuation. After the acquiring credit union determined the fair value of the assets and liabilities it compared these amounts to the entity value calculated in Step One to determine a new goodwill amount. If the new goodwill was greater than the book value of the existing goodwill, then the existing goodwill was not impaired. If the new goodwill was less than the book value of the existing goodwill, then the existing goodwill had to be written down to the new amount subject to a floor of zero. In other words, if the new goodwill was zero the entire book value of the goodwill had to be written off.

Risk-Based Capital Implications

In October 2015, the NCUA issued revised risk-based capital rules which become effective on January 1, 2019. The final rule increases the minimum risk-based capital ratios for credit unions to 8.00% in order to be considered "adequately capitalized" and to 10.00% to be considered "well capitalized". In calculating the risk-based capital ratio, the risk-based capital amount will be divided by the organization's risk-weighted assets. Risk-based capital will be based on total capital less certain deductions including goodwill and the NCUSIF capitalization deposit.

[6] FAS ASC 350-20-35-4
[7] FAS ASC 350-20-35-11

The goodwill deduction is subject to a 10-year phase in for goodwill arising from a supervisory merger or combination that was completed on or before December 28, 2015. The goodwill arising from these transactions can be included in risk-based capital until January 1, 2029.

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Real Return Analyses

Outsourced ALM Advisory:
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Goodwill Impairment Testing
ASC 310-30

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Troubled Debt Restructurings (TDRs)
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For additional details on Wilary Winn's services, please visit our website at www.wilwinn.com

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