ACCOUNTING FOR PURCHASED LOANS: WHAT TO KNOW IF YOU’RE CONSIDERING AN ACQUISITION

PRESENTED BY:

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Sr. Risk Management Consultant

Kevin Abbas
Sr. ALLL Specialist

Wednesday February 18th, 2015
Questions

+ A copy of the slides and webinar recording will be emailed to you following the webinar
+ To ask a question during the webinar, enter it into the chat box in the GoToWebinar panel on right side of screen:
+ Brief Q&A held at end of webinar
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+ Awards
  
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  + Named to Deloitte’s Technology Fast 500
  + NC Tech Awards: Excellence in Customer Service
Who will be speaking?

**Tim McPeak**
Sr. Risk Management Consultant

**Kevin Abbas**
Sr. ALLL Specialist
Learning Objectives

+ Banking landscape
+ Accounting for purchased loans: Implications and regulations
+ Key challenges
+ Day 1 vs. Day 2 accounting
+ ASC 310-20 / FAS 91 vs. ASC 310-30 / SOP 03-3
+ Examples
Banking Landscape: a Wave of M&A
Number of Commercial Banks – Past 10 yrs

Source: Federal Financial Institutions Examination Council (US)
Shaded areas indicate US recessions - 2015 research.stlouisfed.org
“Costs are higher. Capital requirements are higher… Revenue growth is slower and your profit margin is slimmer. That’s driving smaller banks into the arms of larger banks, which are better positioned because they enjoy economies of scale.”

Tony Plath – Finance Professor UNC-Charlotte
Accounting for Purchased Loans

+ Additional accounting / regulatory complexities

+ Regulations are not explicit

+ Unique handling in the Allowance for Loan and Lease Losses (ALLL)
Key Challenges

+ Understanding Day 1 vs. Day 2 accounting
+ Determining the appropriate accounting standard(s) to apply (e.g., ASC 310-20, ASC 310-30)
+ Handling the complexities of each standard
+ To pool or not to pool – that is the question
+ Determining the appropriate ALLL reserve levels
“Day One” Accounting

+ Often referred to as “Fair Value Accounting” or GAAP Purchase Accounting”

+ All acquired loans are initially measured at their fair value, which includes estimation of life-of-loan credit loss

+ No longer is any associated ALLL carried over to acquirer’s balance sheet with loans
“Day Two” Accounting

Accounting for the loans after the financial close date of the business combination

Two prevailing standards

- ASC 310-20 (FAS 91)
- ASC 310-30 (SOP 03-3)
An Introduction to the Standards

+ **ASC 310-20 / FAS 91**
  + Non-Credit Impaired
  + Recognizes income based on contractual cash flows

+ **ASC 310-30 / SOP 03-3**
  + Credit Impaired
  + Recognizes income based on expected cash flows
Loans that are **not** considered “credit impaired” at the time of purchase

Used when the contractually obligated principal and interest cash flows are expected to be received on an acquired loan

The purchase discount or premium will generally be accreted (amortized) into income on a level yield over the expected life of the loan
ASC 310-20 (FAS 91)

**UPB = $100,000**

- **Interest Rate**: $2,000
- **Loss in Cash Flows**: $3,000
- **Initial Investment (Fair Value)**: $95,000

Accrete all discounts into income over expected life.
As a result of using contractual cash flows:

- Should any credit losses be incurred on these loans subsequent to acquisition, a provision to the ALLL would be required.

- Remember there is no “carry over” of the ALLL recorded under this standard.
## FAS 91 (ASC 310-20) Loans

**February 2014 - Balances**

<table>
<thead>
<tr>
<th>Loan Type Code</th>
<th>Total Loan Balance</th>
<th>Loss Rate</th>
<th>Loss Reserve</th>
<th>Fair Value Premium / Discounts</th>
<th>Additional Allowance Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-4 FAMILY FIRST MORTGAGE (1)</td>
<td>$1,939,080.26</td>
<td>4.1700%</td>
<td>$80,859.65</td>
<td>$-75,000.00</td>
<td>$5,859.65</td>
</tr>
<tr>
<td>1-4 FAMILY JUNIOR MORTGAGE (1)</td>
<td>$10,122,430.87</td>
<td>4.3300%</td>
<td>$438,301.26</td>
<td>$-427,512.00</td>
<td>$10,789.26</td>
</tr>
<tr>
<td>AGRICULTURE (NON-RE) (1)</td>
<td>$5,020,500.00</td>
<td>5.6500%</td>
<td>$283,658.25</td>
<td>$-594,231.00</td>
<td>$0.00</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td><strong>$17,082,011.13</strong></td>
<td></td>
<td><strong>$802,819.15</strong></td>
<td></td>
<td><strong>$16,648.90</strong></td>
</tr>
</tbody>
</table>
Considered “credit impaired” at time of purchase

Uses the acquirer’s “cash flow expected at acquisition” as the benchmark for calculating the yield on the investment in the loan

Loans that meet both of the following standards must be accounted for under this method:

- The deterioration in credit quality occurred after origination
- Probable that the acquirer will be unable to collect all contractually obligated payments from the borrower

Additional complexities over ASC 310-20 (FAS 91)
Accretable Yield vs. Non-Accretable Difference

+ Loans are initially recorded at purchase price (fair value)

+ Accretable Yield – The amount of expected cash flows that exceed the initial investment in the loan
  + Recognized as interest income on a level yield basis over the life of the loan

+ Non-Accretable Difference – The excess of total contractual cash flows over the cash flows expected to be received at origination
ASC 310-30 (SOP 03-3) Example

Contractual Cash Flows → $100,000
Expected Cash Flows → $80,000
Initial Investment (Fair Value) → $65,000

- Non-Accretable Difference (Contractual CF’s > Expected CF’s)
- Accretible Yield (Expected CF’s > Cost)
+ Not a one-time conclusion
+ Remaining cash flows must be reforecast
+ If expected cash flows improve, it is recognized through an increase in the accretion rate
+ If expected cash flows decrease, it is recognized through a provision to the ALLL
Improvement in Cash Flow Expectations: Example

Components of Acquired Loan Balances

Contractual Cash Flows

Non-Accretable Difference

Accretable Yield

Expected Cash Flows

Accretable Yield

Recorded Investment

Recorded Investment

Original

Revalued w/ Improvement
To pool or not to pool? – That is the question

Can pool together loans of common risk characteristics

- Similar credit risk or risk ratings
- One or more prominent risk rating characteristics

Must document and substantiate

Pooled loans must have been acquired together, or within the same fiscal quarter

- Can then be treated as a single asset
As a result of using expected cash flows:

+ Decreases in expected cash flows are recognize with a provision to the ALLL

+ Again, remember there is no “carry over” of the ALLL recorded under this standard

+ Three (3) valuation methods:
  + Collateral
  + Expected cash flow
  + Cost recovery
ASC 310-30 (SOP 03-3) ALLL Example

Collateral Method:

![Collateral Analysis Diagram](Image URL)
ASC 310-30 (SOP 03-3) ALLL Example

Expected Cash Flow Method:

**Loan Information**
- Customer Name: Blackhawk
- Loan Number: 5000020965
- Carrying Amount (Fair Value): $4,000,000.00
- Remaining Term (Months): 5
- Expected Payment: $1,165,134.00
- **Calculated Yield Rate:** 14.0000%

**Carrying value = Current Balance + Fair Value Premium/Discount integrated/entered for the loan**

**Accretable Yield based on the carrying value (above) and expected payments (below)**

**Loan Schedule**

<table>
<thead>
<tr>
<th>Payment Date</th>
<th>Expected Payment</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/31/2014</td>
<td>$1,165,134.00</td>
<td>$1,022,047.43</td>
</tr>
<tr>
<td>4/30/2014</td>
<td>$1,165,134.00</td>
<td>$896,532.88</td>
</tr>
<tr>
<td>5/31/2014</td>
<td>$1,165,134.00</td>
<td>$786,432.40</td>
</tr>
<tr>
<td>6/30/2014</td>
<td>$1,165,134.00</td>
<td>$689,853.02</td>
</tr>
<tr>
<td>7/31/2014</td>
<td>$1,165,134.00</td>
<td>$605,134.27</td>
</tr>
</tbody>
</table>
Expected Cash Flow Method:
Expected Cash Flow Method:

### Loan Information
- Customer Name: CV Test 04.12.2014
- Loan Number: CV Test 04.12.14
- Remaining Cash to be Collected: $24,500.00
- Cash Collected to Date: $9,300.00
- Write Downs & Allowances: $0.00
- Yield Accreted to Date: $487.88
- Remaining Accractable Yield: $3,312.12

### Loan Schedule

<table>
<thead>
<tr>
<th>Payment Date</th>
<th>Yield %</th>
<th>Beginning Carrying Amount</th>
<th>Cash Flows</th>
<th>Interest Income</th>
<th>Ending Carrying Amount</th>
<th>Allowance Entry</th>
<th>Total Allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/31/2014</td>
<td>0.6007%</td>
<td>$30,000.00</td>
<td>$3,100.00</td>
<td>$180.20</td>
<td>$27,800.20</td>
<td>$0.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>11/30/2014</td>
<td>0.6007%</td>
<td>$27,080.20</td>
<td>$3,100.00</td>
<td>$152.66</td>
<td>$24,412.88</td>
<td>$0.00</td>
<td>$0.00</td>
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<tr>
<td>12/31/2014</td>
<td>0.6007%</td>
<td>$24,142.86</td>
<td>$3,100.00</td>
<td>$145.02</td>
<td>$21,187.88</td>
<td>$0.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>1/31/2015</td>
<td>3.7683%</td>
<td>$21,187.88</td>
<td>$3,500.00</td>
<td>$798.52</td>
<td>$18,486.40</td>
<td>$0.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>2/28/2015</td>
<td>3.7689%</td>
<td>$18,486.40</td>
<td>$3,500.00</td>
<td>$696.71</td>
<td>$15,683.11</td>
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<tr>
<td>3/31/2015</td>
<td>3.7683%</td>
<td>$15,683.11</td>
<td>$3,500.00</td>
<td>$591.06</td>
<td>$12,774.17</td>
<td>$0.00</td>
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</tr>
<tr>
<td>4/30/2015</td>
<td>3.7683%</td>
<td>$12,774.17</td>
<td>$3,500.00</td>
<td>$481.43</td>
<td>$9,756.60</td>
<td>$0.00</td>
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<tr>
<td>5/31/2015</td>
<td>3.7688%</td>
<td>$9,756.60</td>
<td>$3,500.00</td>
<td>$367.67</td>
<td>$6,623.27</td>
<td>$0.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>6/30/2015</td>
<td>3.7688%</td>
<td>$6,623.27</td>
<td>$3,500.00</td>
<td>$249.62</td>
<td>$3,372.88</td>
<td>$0.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>7/31/2015</td>
<td>3.7689%</td>
<td>$3,372.88</td>
<td>$3,500.00</td>
<td>$127.12</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
</tr>
</tbody>
</table>
Expected Cash Flow Method:
### Cost Recovery Method:

<table>
<thead>
<tr>
<th>Payment Date</th>
<th>Beginning Carrying Amount</th>
<th>Cash Flows</th>
<th>Adjustments</th>
<th>Ending Carrying Amount</th>
<th>Interest Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2/28/2014</td>
<td>$102,521.07</td>
<td>$25,000.00</td>
<td>$0.00</td>
<td>$77,521.07</td>
<td>$0.00</td>
</tr>
<tr>
<td>3/31/2014</td>
<td>$77,521.07</td>
<td>$27,500.00</td>
<td>$0.00</td>
<td>$50,021.07</td>
<td>$0.00</td>
</tr>
<tr>
<td>4/30/2014</td>
<td>$50,021.07</td>
<td>$27,500.00</td>
<td>$0.00</td>
<td>$22,521.07</td>
<td>$0.00</td>
</tr>
<tr>
<td>5/31/2014</td>
<td>$22,521.07</td>
<td>$27,500.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$4,978.93</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$107,500.00</strong></td>
<td><strong>$0.00</strong></td>
<td></td>
<td><strong>$0.00</strong></td>
<td><strong>$4,978.93</strong></td>
</tr>
</tbody>
</table>

**Reserve Amount:** $0.00
### Allowance for Loan and Lease Losses Balances and Reserves

<table>
<thead>
<tr>
<th>Description</th>
<th>Balances</th>
<th>Reserves</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FAS 114 (ASC 310-10-35) Loans:</strong></td>
<td>$2,957,364.56</td>
<td>$779,594.89</td>
<td></td>
</tr>
<tr>
<td><strong>FAS 5 (ASC 450-20) Loans:</strong></td>
<td>$376,463,999.20</td>
<td>$19,464,408.58</td>
<td></td>
</tr>
<tr>
<td><strong>SOP 03-3 (ASC 310-30) Loans:</strong></td>
<td>$2,823,730.23</td>
<td>$0.00</td>
<td></td>
</tr>
<tr>
<td><strong>FAS 91 (ASC 310-20) Loans:</strong></td>
<td>$17,082,011.13</td>
<td>$16,648.90</td>
<td></td>
</tr>
<tr>
<td><strong>Total Loans:</strong></td>
<td>$399,327,105.12</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Unallocated Reserves:</strong></td>
<td></td>
<td>$800,000.00</td>
<td></td>
</tr>
<tr>
<td><strong>Total ALLL Reserve:</strong></td>
<td></td>
<td>$21,060,652.37</td>
<td></td>
</tr>
</tbody>
</table>

*This screenshot displays a financial statement showing balances and reserves for different loan categories, along with comments columns for each entry.*
**Facts** Bank A acquires Bank B in a transaction accounted for under the acquisition method in accordance with ASC 805. The loan portfolio acquired includes both impaired and non-impaired loans. Bank A accounts for the impaired loans as PCI loans in accordance with ASC 310-30 and accounts for all non-impaired loans in accordance with ASC 310-20. For the acquired non-impaired loans, Bank A bifurcates the acquisition fair value mark into a credit portion and a non-credit portion when estimating the ALLL needed in subsequent periods.

**Question 10**

Is it proper for Bank A to bifurcate the fair value mark on the acquired non-impaired loans into a credit portion and a non-credit portion when estimating the ALLL in subsequent periods?

**Staff Response**

No. ASC 310-20 does not support such bifurcation between the two components. The entire discount is accreted into interest income, or premium amortized, over the remaining lives of the loans. However, the accretion or amortization related to an individual loan should cease if that loan is placed on nonaccrual. The unamortized discount or premium is part of the recorded investment in the loan against which the need for the ALLL is evaluated.
Items to Remember

+ Increase in M&A Activity

+ With acquisitions, increase in accounting / regulatory requirements

+ Purchased accounting introduces additional complexities

+ Day 1 vs. Day 2 Accounting

+ ASC 310-20 (FAS 91) vs. ASC 310-30 (SOP 03-3)
Contact Information

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Resources

www.sageworksanalyst.com
+ Whitepapers, webinars, thought leadership

The destination website for the ALLL calculation
+ Latest news, peer discussions, industry expert opinions

ALLL Forum for Bankers
+ Commercial Credit Risk Professionals

SageWorks
ALLL
Commercial Credit Risk Professionals
Resources (cont’d)

+ CECL Webinar
+ Fill out form, we’ll email you invite when guidance passed
+ Web.sageworks.com/CECL/

+ 2015 Annual Risk Management Summit (ALLL + ST)
  + Chicago, IL Sept 23 – 25
  + Sageworks.com/Summit

+ Brief survey following webinar: topics for upcoming webinars? Speaker feedback?
Questions?