

# Accounting and Tax Considerations of Acquiring a “Whole Bank” with an LSA

By Jamie Mayer, Tim Cleary and Graham Dyer

*An overview of the accounting and tax considerations related to whole-bank acquisitions with FDIC loss-sharing agreements.*

The economic downturn and accompanying banking crisis have spurred an unprecedented increase in the number of bank failures. Many of these troubled banks are being acquired by healthy banks through Federal Deposit Insurance Corporation (FDIC)-facilitated acquisitions. For qualified banks, acquisitions of these failed banks present significant opportunities to grow aggressively—in asset size, market share and geography—with the risks potentially mitigated through FDIC loss-sharing agreements (LSAs). Under an LSA, the FDIC and acquirer share in the losses of the covered assets in which the FDIC typically reimburses the acquirer for 80 percent of the losses on the covered assets with the acquirer absorbing the other 20 percent.<sup>1</sup> The most common transaction structure is a purchase and assumption (P&A) arrangement, in which the acquirer purchases a “whole bank” with an LSA. This article provides an overview of the accounting and tax considerations related to those types of transactions.<sup>2</sup> Due to the evolving nature of FDIC-facilitated transactions, readers should consult with their advisers for the most current information and interpretations.

## Day-One Accounting Considerations

The acquisitions of failed banks will be accounted for pursuant to Financial Accounting Standards Board (FASB) Accounting Standards Codification™ (ASC) 805, *Business Combinations* (formerly FASB Statement of Financial Accounting Standards No.

141R, *Business Combinations* [FAS-141R]). Effective for business combinations with an acquisition date on or after the beginning of the first annual reporting period beginning on or after December 15, 2008 (January 1, 2009, for calendar year-end entities), the revised guidance in ASC 805 significantly changed the accounting for business combinations.

The following are significant changes made by FAS-141R that are especially relevant to the acquisitions of failed banks:

- Assets acquired, liabilities assumed and non-controlling interests are recognized at fair value under ASC 820, *Fair Value Measurements and Disclosures*, with limited exceptions.
- None of the failed bank’s allowance for loan and lease losses (ALLL) is carried over to the acquirer in purchase accounting. Each acquired loan is recorded at its fair value and there is no initial ALLL for acquired loans.
- Any direct external costs (for example, professional, legal and accounting fees) are expensed as incurred. However, costs related to issuing debt or equity securities that are used to finance the transaction continue to be recognized in ac-

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*The views and interpretations expressed in the article are those of the authors, and the article is not intended to provide accounting or other advice or guidance with respect to the matters covered.*

cordance with the applicable generally accepted accounting principles (GAAP).

- The FDIC’s LSA is considered an indemnification asset, separate from the covered loans, which will initially be recognized and measured on the same basis as the item being indemnified pursuant to the guidance in ASC 805-20-30-18. This is the most common approach; however, the Securities and Exchange Commission (SEC) and FASB have indicated that the LSA asset could be accounted for as a derivative if it also meets the definition of a derivative in ASC 815, *Derivatives and Hedging*. If the LSA is accounted for as a derivative, it will be initially and subsequently recognized at fair value, with changes in fair value recognized in earnings.
- The acquirer would record a gain in the income statement at acquisition if the fair value of the assets obtained less liabilities assumed is greater than the consideration transferred, any equity interests held in the acquiree immediately before the acquisition date and noncontrolling interests in the acquiree. Alternatively, if the opposite is true, goodwill will be recognized.
- Acquirers will need to consider whether a retroactive adjustment to the business combination accounting is necessary as a result of information that is obtained during the measurement period about facts and circumstances that existed as of the acquisition date. The measurement period ends as of the earlier of (a) one year from the acquisition date or (b) the date when the acquirer receives the information necessary to complete the business combination accounting.

### Day-One Tax Considerations

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In response to the thrift industry crisis of the late 1980s and early 1990s, the government provided significant financial assistance to many troubled institutions. To clarify the taxation of this type of financial assistance, Congress enacted Internal Revenue Code Section (“Code Sec.”) 597 as part of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). Code Sec. 597 is very relevant to today’s FDIC-facilitated failed

bank acquisitions and is the primary regulation that governs federally assisted transactions.

The FDIC has a great deal of latitude in providing financial assistance for buyers of failed institutions by providing loans, making capital infusions or forming new legal entities to temporarily hold assets before they are liquidated. Under the Code and Treasury regulations, assistance received from the FDIC is defined as federal financial assistance (FFA).

If a failed bank’s liabilities exceed the value of its assets, the FDIC might implement a “net worth assistance” payment as an inducement to the buyer of the failed bank. This concept is described as “transactional equity” in the P&A agreements and represents the net of the assets and liabilities acquired under the LSA. Typically, this amount is negative and is “funded” by the FDIC. A net worth assistance payment of this type is taxable income to the failed bank and is considered a cash asset acquired by the buyer of the bank.

The majority of FDIC purchase and sale agreements in the past year have been taxable asset transactions as opposed to the acquisition of a failed bank’s stock. The purchase price in a taxable asset sale generally equals the cash paid plus any liabilities assumed. If no cash is paid by the acquirer (as is often the case), the purchase price may approximate the assumed liabilities. For tax purposes, when liabilities are assumed as consideration from the buyer, they are determined by the contractual amounts due to the failed bank’s depositors and other debts assumed by the buyer. This amount can be different from the measurement of liabilities determined under purchase accounting.

Taxable asset acquisitions allocate the purchase price among the acquired assets based upon categories of assets using the “residual method” as provided in Code Secs. 338 and 1060. The tax rules for FDIC-assisted sales do not allow for the allocation of any purchase price to an LSA. As previously discussed, an acquirer recognizes an LSA asset for accounting purposes. However, for tax purposes, a Day-One book-versus-tax temporary difference is recognized since the LSA asset is not recognized for tax purposes. This book-versus-tax difference is reallocated from the LSA to loans and other acquired assets—such as branches and core deposit intangibles—consistent with the residual method.

Under the residual method, the purchase price is allocated to the acquired asset pursuant to seven different asset classifications. The first two asset classes are cash and certain general deposit accounts (Class I) and actively traded personal property (Class II). Acquired loans subject to an LSA are considered Class II assets. In FDIC-assisted sales, if the fair market value of the Class I and Class II assets exceeds the allocated purchase price, the difference will be considered FFA and will be considered taxable income for the acquirer ratably over six years. This possibility needs to be considered as a Day-One tax issue.

## Subsequent Accounting Considerations

ASC 805 provides limited specific guidance on the subsequent accounting for acquired assets and liabilities assumed in a business combination. Rather, ASC 805 states that “in general, an acquirer shall subsequently measure and account for assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination in accordance with other applicable GAAP for those items, depending on their nature.” In the acquisition of a failed bank, the most significant items that require subsequent accounting considerations are the acquired loans and the related LSA.

### Accounting for Acquired Loans

At acquisition, the acquirer would need to evaluate each individual acquired loan to determine if the loan has evidence of deterioration of credit quality since origination, and it is probable at acquisition that the acquirer will be unable to collect all contractually required payments from the borrower. If the individual loan has both of those characteristics, it shall be accounted for in accordance with ASC 310-30, *Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality* (formerly Statement of Position (SOP) 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*). Under ASC 310-30, the expected cash flows that exceed the initial investment in the loan (fair value) represent the “accretable yield,” which is recognized as inter-

est income on a level-yield basis over the life of the loan. The accretable yield is not recognized in the statement of financial position but is disclosed in the notes to the financial statements. At each subsequent reporting date, the acquirer is required to update its cash-flow expectations.

If the individual loan does not have both characteristics discussed in the previous paragraph, the difference between the fair value of the loan at acquisition and the amortized cost of the loan would be amortized or accreted into income using the interest method as specified in ASC 310-20, *Receivables—Nonrefundable Fees and Other Costs* (formerly FAS-91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*).

In applying the aforementioned guidance, acquirers should consider the following:

- A loan identified by the acquiree as impaired or nonperforming is a good starting point for determining whether the loan meets the scope of ASC 310-30. However, the acquirer will need to evaluate each individual loan to determine if it meets the scope of ASC 310-30.
- Once it has been determined that a loan meets the scope of ASC 310-30, the acquirer will have an accounting policy election for subsequently accounting for each loan within its scope individually or with other similar loans as a pooled single asset. Due to the complexities and frequency of updating cash-flow estimates, it may be operationally easier to aggregate loans with common risk characteristics. However, this decision could affect disclosures and regulatory reporting.
- Since the subsequent accounting and required reporting to the FDIC can be complex, entities should establish policies and procedures that cover the acquired covered assets and the LSA.
- Many accounting systems are not able to handle the accounting requirements of ASC 310-30; therefore, the acquirer may need to upgrade its financial reporting suite.
- ASC 310-30-55 provides various illustrative examples that are helpful in understanding the unique accounting requirements in ASC 310-30.
- The SEC’s *Areas of Frequent Staff Comment—Financial Institutions*<sup>3</sup> includes areas of staff comment related to FDIC-assisted transactions.

- The American Institute of Certified Public Accountants (AICPA) recently posted to its Web site a letter<sup>4</sup> the AICPA Depository Institutions Expert Panel (DIEP) sent the SEC’s Office of the Chief Accountant summarizing its understanding of the SEC staff’s view of how discounts related to loan receivables acquired in a business combination or asset purchase should be accreted into earnings. The letter indicates that two divergent views have developed regarding loans that are not in the scope of ASC 310-30 but have the following three characteristics: they are acquired in a business combination or asset purchase; they result in the recognition of a discount attributable, at least in part, to credit quality; and they are not subsequently accounted for at fair value. The disagreement lies in whether the loan discount should be accreted using ASC 310-20 or ASC 310-30. The letter documents the DIEP’s understanding that the SEC, absent further standard setting in this area, would not object to an entity’s use of either ASC 310-20 or ASC 310-30. The SEC would expect an entity to disclose the accounting policy election and apply the policy consistently. Further, if an entity elects a policy based on expected cash flows, it should follow all of the accounting and disclosure guidance in ASC 310-30. Acquirers should consult with their auditors or accounting advisors as to the application of such an accounting policy election.

### Accounting for an LSA

An LSA asset should be reported on the balance sheet separately from the asset(s) to which it corresponds. If the LSA is accounted for as an indemnification asset, it is subsequently remeasured each reporting date on the same basis as the indemnified asset or liability, subject to any contractual limitations on its amount. Although the covered assets may be carried at various bases (for example, available-for-sale investment securities will be recognized at fair value, some loans will be accounted for under ASC 310-20 and other loans under ASC 310-30), the indemnification asset represents a single asset. Amounts that are subsequently measured on a basis other than fair

value are also subject to management’s assessment of collectibility.

### Interaction of Subsequent Accounting for Acquired Loans and Related LSA Indemnification Asset

The following examples illustrate the interaction of the subsequent accounting for the acquired loans and the related LSA indemnification asset:

- If there is credit deterioration in the expected cash flows of the loans covered by the LSA, the acquirer would recognize an ALLL and corresponding provision for loan and lease losses related to the loans. In addition, the acquirer would reevaluate the indemnification asset and recognize in noninterest income an increase in the indemnification asset for the portion covered by the FDIC. The amounts recognized in earnings would be reported gross. This treatment is the same regardless of whether the loan is accounted for under ASC 310-20 or ASC 310-30.
- For loans accounted for under ASC 310-20, an improvement in the credit quality of the loans covered by the LSA would result in the reduction of any ALLL established after the acquisition. The amortization or accretion of any premium or discount paid on the loan would not be affected unless the loan is returned to accrual status. The acquirer would reevaluate the indemnification asset and recognize through a charge to noninterest income a decrease in the indemnification asset.
- For loans accounted for under ASC 310-30, an improvement in the credit quality of the loans covered by the LSA would also result in the reduction of any ALLL established after the acquisition. However, if the acquirer determines that the expected cash flows are greater than its estimate at acquisition, the acquirer would compute a revised effective yield and recognize the increase in the accretable yield amount over the remaining life of the loan. The acquirer would reevaluate the indemnification asset and recognize through a charge to noninterest income a decrease in the indemnification asset.

## Subsequent Tax Considerations

Tax reporting requirements have several components and issues, each with their own set of complexities. Under current tax rules, interest income is generally based upon the contractual relationship with the debtor and is computed using the principal amount outstanding, the original interest rate and other terms of the loan. This amount will be different from income recognized under ASC 310-20 or ASC 310-30 and will create a book-versus-tax difference that will need to be tracked.

Loans acquired for an amount below the face value are purchased with a market discount. The market discount represents potential taxable income that must be accrued and recognized when received. For example, if a \$100,000 loan was acquired for \$80,000 and the debtor refinanced the full amount of the loan with another bank, \$20,000 of market discount is realized and will be recognized as ordinary income. Absent a refinancing or similar event, the accrued market discount for acquired loans must be tracked until received. Acquirers of loans with market discount can elect to recognize the market discount in taxable income currently under either a constant interest-rate method or ratably over the life of the loan.

A payment received under an LSA is considered FFA and may be recognized as taxable income. If an acquired loan is charged off, payments received from the FDIC must be considered realized when paid. Assume the \$100,000 loan described earlier is charged off by the acquirer and \$80,000 is received from the FDIC under the LSA. The determination of the acquirer's taxable income would include the realization of the \$80,000 FDIC payment offset by the tax basis of \$80,000 in the acquired loan. If for some reason the amount realized exceeded its basis, the acquirer would have an increase to taxable income. It is, of course, possible to have a decrease to taxable income if the tax basis of a loan exceeds the amount realized from the FDIC, for example, when accrued market discount income is recognized for tax but not book purposes. As noted above, the difference between book and tax basis of a loan covered by an LSA can be different for a number of reasons, and these differences will

need to be reconciled when an LSA payment is received from the FDIC.

As with any acquisition, an FDIC-assisted purchase can increase a bank's tax footprint to include new state and local taxing jurisdictions. In some cases, new consolidated or unitary group reporting may be required, revenue sourcing methodologies will need to be considered, and previously recorded deferred tax amounts may need to be revalued.

### Endnotes

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<sup>1</sup> At the date of this writing, we understand that the FDIC was in the process of prospectively eliminating the 95/5 loss sharing that was present in many deals prior to April 2010.

<sup>2</sup> Visit [www.grantthornton.com/troubledbanks](http://www.grantthornton.com/troubledbanks) to download the white paper, *Troubled Bank Opportunities: What You Need to Know about FDIC-Assisted Transactions*.

<sup>3</sup> Stephanie L. Hunsaker, *Areas of Frequent Staff Comment—Financial Institutions* (SEC, Division of Corporate Finance, Dec. 2009), [www.sec.gov/news/speech/2009/slides1209slh.pdf](http://www.sec.gov/news/speech/2009/slides1209slh.pdf).

<sup>4</sup> Confirmation letter (AICPA Depository Institutions Expert Panel Dec. 18, 2009), <http://aicpa.org/download/acctstd/Confirmation-letter-on-Day-2.pdf>.

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