

Accounting for FDIC-assisted transactions: Acquisition of loans, application of ASC 310-30 and other issues

June 2010

BALANCE SHEET
CNO W. L. W. M. M. S.
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	2006	2005
	€ 000	€ 000
Current Assets		
Cash	70.289	62.935
Debtors	21.781	41.507
Cash balances	21.781	11.889
	<u>113.851</u>	<u>116.331</u>
Fixed Assets		
Tangible Assets		6000
Investments	6.875	71
Investment in associates	2.925	
Share of associates	12.608	67
Share of subsidiaries		1.000
	<u>22.408</u>	<u>1.038</u>
Current Liabilities		
In current assets	109.760	170.161
Total assets less liabilities	21.200	19.200
Total assets less liabilities	20.610	18.376
Current liabilities	11.742	11.637
Non-current liabilities		
Net Assets	23.227	2.527
Capital reserves		
Capital reserves	2.524	2.521
Share premium account	415	295
Capital reserves	15	7
Share of associates	-	600
Share of subsidiaries	24.387	1.000
Shareholders' Equity	27.200	21.101
Minority interests		3.051
	<u>27.200</u>	<u>24.152</u>

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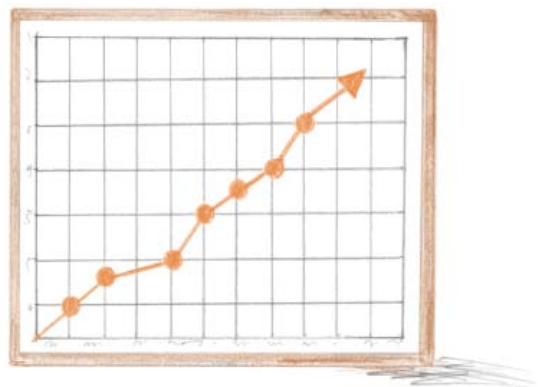
Introduction

It seems that far too often, another bank failure has made headlines. Unfortunately, news of failed banks has become a recent sign of the times. The current level of troubled financial institutions has not been experienced since the savings and loan crisis of the late 1980s and early 1990s. In fact, the FDIC has projected the current wave of bank failures will extend through 2013, with a cost to taxpayers of approximately \$100 billion. The number of at-risk banks was estimated at 702 as of Dec. 31, 2009, based on the latest FDIC quarterly report — this means approximately nine percent of U.S. financial institutions (with assets totaling approximately \$402 billion) are considered at risk. These figures have increased drastically over the past few years: 552 institutions were considered at risk as of Sept. 30, 2009, a significant spike from the estimated 252 at-risk institutions as of Dec. 31, 2008. During the fourth quarter of 2009 alone, failed institutions totaled 45, while an additional 43 were absorbed through acquisitions. There is another telling indication of the challenging environment for banks: Only 31 new bank charters were created in 2009, which the FDIC reports as the lowest volume since 1942.¹

Acquiring failed banks at a potentially significant discount can present a unique opportunity to expand an institution's branch footprint, enhance the deposit base and provide value to shareholders.

These figures are certainly troubling. However, as discussed in our last white paper,² financial institutions that have remained well-capitalized throughout these difficult times, and that meet the FDIC's requirements for bidding on institutions in FDIC receivership, face a significant and rare opportunity to grow and enhance their franchise value through failed bank acquisitions. Acquiring failed banks at a potentially significant discount can present a unique opportunity to expand an institution's branch footprint, enhance the deposit base and provide value to shareholders.

This white paper will delve further into failed bank acquisitions, including certain concepts discussed in our last communication on acquiring failed banks. Specifically, we'll tackle the challenges in applying GAAP purchase accounting to the acquisition of loans, including troubled loans. As with all business combinations, the assumption of a failed bank is not without its challenges. We'll discuss the pitfalls of which your organization should be cognizant, and outline a few best practices that can help your acquisition go as smoothly as possible.



¹ "Quarterly Banking Profile," FDIC, Dec. 31, 2009. www2.fdic.gov/qbp/2009dec/qbp.pdf

² *Troubled Bank Opportunities: What you need to know about FDIC-assisted transactions*, Grant Thornton LLP (2010).

Refresher on purchase accounting for loans: New GAAP versus old

By now, all banks and thrifts have adopted the revised purchase accounting standards promulgated under FASB Accounting Standards Codification™ (ASC) Topic 805, *Business Combinations* (previously known as FASB Statement of Financial Accounting Standards No. 141(R)). In order to understand the nuances of accounting for acquired loans, and specifically those acquired in a failed bank acquisition, we must first have a solid foundation in these revised purchase accounting requirements and their impact on a standard business combination. This will make it easier to understand the differences that make the acquired loan portfolio of a failed bank unique.

The following significant changes under ASC Topic 805³ are especially relevant to the acquisitions of financial institutions:

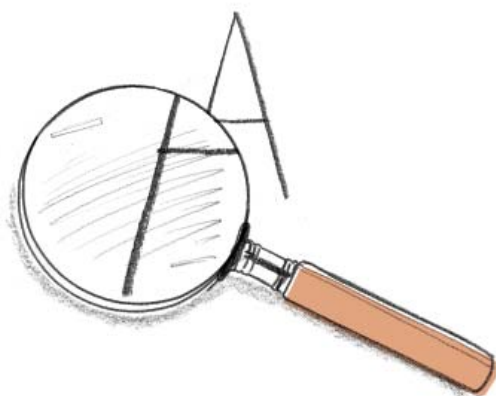
- Assets acquired, liabilities assumed and noncontrolling interests are recognized at fair value under ASC 820, *Fair Value Measurements and Disclosures* (formerly FASB Statement 157, *Fair Value Measurements*), with limited exceptions.
- None of an acquired institution's allowance for loan and lease losses (ALLL) is carried over to the acquirer enterprise in purchase accounting. Each acquired loan is recorded at fair value — there is no initial ALLL allowed for any acquired loans.
- Any direct external costs (e.g., accounting, legal or other professional services fees) are expensed as incurred. However, costs related to issuing debt and equity securities that are used to finance the transaction continue to be recognized in accordance with the applicable (and unrevised) GAAP.

Perhaps the most drastic change under the revised purchase accounting standards is the treatment of the ALLL. Accounting for bank acquisitions has never been without nuance, and, previously, bank acquisitions were given special treatment. You may recall that under the previous, unrevised provisions of Statement 141 (SFAS No. 141, *Business Combinations*), banks were given an exception that allowed the acquirer to bring over the ALLL in purchase accounting (in most instances). This was among the few exceptions to the fair value purchase accounting requirements in that standard. Without this exception in the accounting rules, the consolidated balance sheet line item for net loans will now contain the acquirer's pre-existing loan portfolio with its corresponding ALLL, plus the acquired loans at fair value, with no incremental addition to the ALLL. From the average financial statement user's perspective, it will appear that loans outstanding increased with no corresponding increase to the ALLL, resulting in a lower ratio of ALLL to total loans.

Perhaps the most drastic change under the revised purchase accounting standards is the treatment of the ALLL.

³ For more on ASC Topic 805, read our earlier white paper, *Troubled bank opportunities: What you need to know about FDIC-assisted transactions*, at www.GrantThornton.com/troubledbanks. You can also visit our Business Combinations 141R Resource Center, which assists our professionals and clients in dealing with these complex issues. In addition, our banking publication, *Currency*, has featured articles such as "Business combinations: How will Statement 141R change current practices?" which discusses how the new business combination accounting literature impacts financial institutions.

Because the ability to “carry over” the ALLL of the acquired bank does not exist in the revised purchase accounting standards under ASC Topic 805, the need for clear and robust disclosure surrounding bank mergers is more important than ever. Clear disclosure will ensure that users of financial statements obtain a complete understanding of the composition of the loan portfolio. SEC registrants are expected to include concise footnotes to their financial statements, along with explanatory management discussion and analysis (MD&A). After all, MD&A is supposed to convey management’s perspective on the events, circumstances and conditions that exist or may occur, and accordingly financial statement users should be provided with the information necessary to understand the relationships between items such as the allowance (or lack thereof) and the underlying loans to which it relates.



The ongoing accounting for acquired loans (again, other than those we’re about to discuss) continues under the basic loan accounting principles established in ASC 310-20, *Receivables – Nonrefundable Fees and Other Costs* (ASC 310-20, or pre-codified SFAS No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*), in which interest income is accrued on a level-yield basis for performing loans. For income recognition purposes, this method assumes that all contractual cash flows will be collected. Post-acquisition date, an ALLL may need to be established for the acquired portfolio through a provision charged to earnings for credit losses incurred subsequent to acquisition. For loans accounted for under the basic loan accounting model (ASC 310-20), the loss would be measured based on the shortfall in relation to the contractual note requirements.

In addition to loans, any other assets, liabilities and agreements acquired or assumed as part of the business combination must be analyzed to determine if they hold value. To the extent they do, they must also be recognized on the balance sheet at their fair value. This requirement applies to any loss-sharing agreement (LSA) with the FDIC. LSAs have typically been included as a part of FDIC-brokered transactions during the past 18 months.

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Accounting for loans acquired with deteriorated credit quality

In December 2003, the AICPA issued Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3 or its codified reference, ASC 310-30). The provisions of ASC 310-30 were applicable under the old purchase accounting rules and remain unchanged by the revised purchase accounting prescribed under ASC Topic 805. ASC 310-30 warrants special attention, as its provisions set forth the accounting treatment for acquired loans with evidence of deteriorated credit quality. Because an acquired failed bank will likely hold a large inventory of loans with deteriorated credit quality, the guidance in ASC 310-30 will likely be applicable and its application may be entirely new to the acquirer.

Understanding ASC 310-30

The provisions of ASC 310-30 strike a similar chord with the updated purchase accounting rules under ASC Topic 805, in that no ALLL is brought over in purchase accounting, as presumably, the fair value of such loans includes any applicable discounts for credit quality. In some ways, ASC 310-30 was ahead of its time in its treatment of an ALLL for acquired loans. As mentioned earlier, the purchase accounting standards were eventually revised to require similar treatment for all acquired loans and any corresponding ALLL. After the acquisition date, income for loans falling under ASC 310-30 should be recognized on a level-yield basis, with the yield predicated on the amount and timing of expected future cash flows.

In some ways, ASC 310-30 was ahead of its time in its treatment of an ALLL for acquired loans.

Fundamentally, the difference between the basic model of loan accounting in ASC 310-20 and ASC 310-30 accounting is that ASC 310-30 uses the acquirer's "cash flows expected at acquisition" (a defined term) as the benchmark for calculating the yield (interest income) on the investment in the loan and for purposes of determining whether the loan is impaired and how that impairment should be measured. This is in contrast to the basic model that measures yield and impairment using contractual cash flows as the benchmark.

Which loans fall within the scope of ASC 310-30?

Before we discuss the intricacies of accounting for loans under ASC 310-30, we must first correctly identify the population of loans falling under its provisions. Acquired loans that meet the following two criteria must be accounted for pursuant to ASC 310-30:

- There must be evidence of deterioration in credit quality subsequent to origination
- It must be probable that the acquirer will be unable to collect all contractually required payments from the borrower

The determination of whether acquired loans are to be accounted for under ASC 310-30 must be made at acquisition on a loan-by-loan basis, and loans cannot transition between ASC 310-30 and ASC 310-20 subsequent to the acquisition date. These two criteria are essential to reaching the appropriate accounting conclusion, so they deserve further discussion.

Requirement A – Is there evidence that the deterioration in credit quality has occurred subsequent to origination?

At first glance, this determination may appear simple. We can all take a quick look at a loan’s performance and underlying attributes to make a judgment call as to whether credit concerns exist. Factors such as a borrower’s credit score, sources and uses of cash, payment history, and debt-to-income levels are among the traditional ways of considering credit quality.

However, to qualify for accounting under ASC 310-30, this deterioration in credit quality must have occurred subsequent to origination. Accordingly, a loan that was sub-prime from its origination may or may not fall into the ASC 310-30 bucket. If said sub-prime loan has continued to perform based on the contractual terms, then chances are good that deterioration in credit quality did not occur subsequent to acquisition.

If a loan is nonperforming when acquired, the credit score has declined significantly or the loan-to-value ratio has increased significantly, this would all be evidence of deterioration in credit quality. Additionally, an acquiring institution may use its fair value analysis of the loans acquired to contribute to its ASC 310-30 determination. When loans are marked to fair value, a discount relative to credit quality is commonly determined separately from other components of the discount. A significant discount with a substantial credit quality component may be evidence that credit quality has deteriorated since origination. As with many areas under GAAP, management judgment is required in reaching this determination.

Often, the loans can be easily separated into three categories: in-scope, out-of-scope and “maybe.”

Requirement B – Is it probable that the acquirer will be unable to collect all contractually required payments from the borrower?

In short, a conclusion must be reached as to whether the acquirer will be successful in collecting all contractually required principal and interest under the loan agreement. Generally, this determination should be made without consideration of cash flows that may be obtained from disposal of collateral or enforcement of personal guarantees. If the likely source of repayment will be the proceeds from foreclosure, then this criteria is usually met.

If the individual loan meets both of the above requirements, it should be accounted for in accordance with ASC 310-30. Although the above analysis must be performed on a loan-by-loan basis, there is often opportunity to automate the process by electronically screening acquired loans using common loan characteristics typically captured in loan accounting systems, such as past due status, frequency of late payment and even credit score changes. Often, the loans can be easily separated into three categories: in-scope, out-of-scope and “maybe.” Then the accounting team can focus their efforts on the “maybes.”



Recognizing income under ASC 310-30

Under ASC 310-30, the expected cash flows that exceed the initial investment in the loan (i.e., the fair value of the loan) represent the “accretable yield,” which is recognized as interest income on a level-yield basis over the life of the loan. The difference between the cash flows expected at acquisition and the total contractual cash flows is considered the “non-accretable difference.”

The accretable yield and non-accretable difference are not displayed on the balance sheet, but rather disclosed in the notes to the financial statements under the disclosure provisions of ASC 310-30. (In fact, the non-accretable difference is only disclosed once, in the period of the acquisition, and it need not be tracked thereafter.) The net effect of calculating the yield on the basis of expected, rather than contractual, cash flows is a lower yield than would be recognized under ASC 310-20, and one that contemplates some level of nonperformance by the borrower. The result is a level recognition of income over the life of the loan and, assuming the acquirer’s cash flow expectations are met, no loan loss provisions hitting the income statement.

Under the cost-recovery method, no income is accrued; rather, income is recognized only after the basis (i.e., the carrying amount) is recovered through cash collections.

Accordingly, to calculate accretable yield, two factors must be determined:

- The amount of future cash flows anticipated to be received
- The timing over which the expected cash flows will be received

Herein lies one of the most challenging aspects of accounting for acquired loans under ASC 310-30. To the extent these factors cannot be reasonably estimated, ASC 310-30 does allow for the loan to be placed in nonaccrual status and for other reasonable accounting methods to be utilized. The most common of these alternative methods is the cost-recovery method. Under the cost-recovery method, no income is accrued; rather, income is recognized only after the basis (i.e., the carrying amount) is recovered through cash collections. Once the carrying amount is recovered, any future cash flows are recognized directly to earnings as interest income.

However, the use of cost-recovery and other alternative methods is typically discouraged unless significant concerns exist related to the predictability of the timing and amount of future cash flows. Practically speaking, these methods are typically restricted to loans with inherently unpredictable repayment terms. In failed bank transactions, the timing of cash flows for many loans may be estimated through consideration of the time that will elapse from taking a nonperforming loan at the acquisition date through the foreclosure process, including the estimated costs to sell. Other cash flow estimates can be obtained in the event that a loan is restructured, possibly as a troubled-debt restructuring, assuming management believes the concessionary terms will result in a higher likelihood of collection.

As cash flow projections are typically a critical component in determining an acquired loan's fair value for certain types of loans, it is likely that such an analysis will be completed and available to management for the purpose of applying ASC 310-30. Also, ASC 310-30 allows for loans with common risk characteristics to be pooled and the cash flows estimated for the pool as a single composite asset. An acquirer may have greater confidence in the cash flow projection for a large pool of loans than for a projection related to any of the individual loans in the pool. These cash flow projections should also mirror the cash flow projections used to value any indemnification asset arising from an LSA in a transaction to acquire an institution in FDIC receivership.

Changes in estimates of cash flows

Assuming that a reasonable estimate of the timing and amount of future cash flows can be predicted, the accretable yield is then recognized on a level basis over the expected life of the loan. As with all estimates in accounting, we must re-analyze on a periodic basis to determine how actual performance compares with projected performance. We typically recommend that our clients revisit their projections on at least a quarterly basis, and we believe regulators have the same expectation.

To the extent that loans accounted for under ASC 310-30 are performing better than originally expected, and this higher performance is expected to continue, the yield should be prospectively revised upward based on the new estimate of cash flows exceeding the investment in the loan. Conversely, loans underperforming their initial cash flow projections require the recognition of impairment, accomplished through the provision for loan losses sufficient to reduce the carrying amount and maintain the same yield determined at acquisition.



As with all estimates in accounting, we must re-analyze on a periodic basis to determine how actual performance compares with projected performance.

These are highly technical and challenging requirements for many institutions. Complying with the requirements of ASC 310-30 often calls for the use of a knowledgeable third party for both valuation and accounting consultations, as well as obtaining additional assistance in-house. Additionally, most institutions do not already have a core banking system that is configured to handle the complexities of accounting for acquired loans under this accounting standard. Consequently, some institutions are upgrading their core banking systems in order to comply with this standard.

The good news is that when these loans are acquired via an FDIC-facilitated transaction, institutions can build these costs into their bids and, in essence, have the FDIC “pre-pay” these costs for the institution. Additionally, once the institution has a clear and efficiently operating system of controls in place for accounting for acquired loans under ASC 310-30, it will likely find itself at a significant advantage when compared with other institutions, and will be in a position to realize true economies of scale in future acquisitions.



The good news is that when these loans are acquired via an FDIC-facilitated transaction, institutions can build these costs into their bids and, in essence, have the FDIC “pre-pay” these costs for the institution.

Pooling of certain acquired loans

Another ASC 310-30 concept that merits further attention is the option of pooling, whereby loans possessing common risk characteristics that are acquired together or during the same fiscal quarter may be aggregated and treated as a single asset. For some institutions, pooling acquired credit-impaired loans may be more efficient than accounting for each loan separately. When pooled, an aggregate yield is established for the combined asset. The pool is then treated as one asset for the purpose of applying ASC 310-30.

However, it should be emphasized that under the pooled method, each loan comprising the aggregated asset must individually meet the eligibility requirements of ASC 310-30. Accordingly, it is inappropriate to account for a pool of loans under ASC 310-30 simply because the majority of loans meet its criteria. In determining whether the loans under consideration contain similar risk characteristics, the acquirer may consider the loan type, term, expected means of repayment, or other criteria deemed appropriate.

It should also be noted that once the decision has been made to pool, the integrity of the pool should be maintained throughout its life. Accordingly, loans should not be added to the pool subsequent to the quarterly period of its initial assembly. Likewise, loans should not be removed from the pool absent events such as foreclosures, write-offs and if loans are subsequently sold. To the extent that expected cash flow revisions are needed for the pooled asset, they should be measured and accounted for in the same method described above for individual loans.

When a loan must be removed from a pool (for instance, in the case of foreclosure), the institution must determine the carrying amount of the loan being removed. This generally requires that a policy be adopted for how this will be accomplished, so that this determination is made consistently and systematically. For example, some institutions allocate the carrying amount based on the individual loan's relative initial fair value.⁴ 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 should neither increase nor decrease as a direct result of removing a loan from the pool.

Many institutions acquiring failed banks in FDIC receivership are electing the pooling option for residential and other consumer loans, as defined under the FDIC's LSA, while commercial loans as defined under the LSA are often accounted for on a loan-by-loan basis. Commercial loans can be pooled if they meet the pooling criteria, but we do not often see this. Pooling of a loan portfolio has several benefits, including higher confidence in cash flow expectations, a reduced administrative burden and simplification of the analysis of changes in cash flows of the portfolio. Some institutions believe that projecting cash flows for a single consumer/residential loan is impractical; and that projection of cash flows on a pooled basis results in a more accurate assessment, minimizing the individual impact of "winners" and "losers."

Applying ASC 310-30 accounting to other acquired loans

Recently, the SEC has not objected to registrants applying ASC 310-30 by analogy to substantially all acquired loans in a failed bank transaction, not just those that would require such treatment under the standard.⁵ Although this change has not been formally incorporated into the Accounting Standards Codification, it has become an accepted practice and in most cases, is not objected to by the major accounting firms. Certain institutions have been applying ASC 310-30 to substantially all acquired loans for several reasons, including:

- They are already investing in the necessary people, processes and systems to fully implement ASC 310-30 for loans that are required to be accounted for under the standard.
- They are already required to perform the necessary cash flow projections to account for any indemnification asset arising from an LSA, and thus the accounting for the ASC 310-30 loans can benefit from that effort.
- Accounting for loans under ASC 310-30 has an income leveling effect that may be attractive to the institution, along with lower loan loss provisions.
- Loans accounted for under ASC 310-30 that are not performing per the loan contract, but are performing based on cash flow and accretable yield expectations determined at date of acquisition are not considered impaired assets under GAAP.

Recent FASB guidance

The FASB recently issued ASU 2010-18⁶, an update to ASC 310-30, to clarify that a creditor should not apply troubled debt restructuring accounting and disclosure guidance to loans included in a pooled asset under ASC 310-30. However, the troubled debt restructuring guidance in ASC 310-40-15-4 through 15-12 continues to apply to acquired loans within the scope of ASC 310-30 that a creditor accounts for individually.

⁴ However, in many circumstances individual loans are not marked to fair value, but rather the fair value mark occurs at the pooled level. In this case, a rational method for allocating fair value should be used.

⁵ Confirmation letter, AICPA Depository Institutions Expert Panel, Dec. 18, 2009. <http://aicpa.org/download/acctstd/Confirmation-letter-on-Day-2.pdf>

⁶ Read this ASU at <http://www.fasb.org>.

Summary

Accounting for acquired loans, specifically those obtained in connection with an FDIC-assisted transaction, is a highly technical and complex area of GAAP, and one that typically requires investments in qualified people, processes, internal controls, accounting systems and a willingness to seek guidance from third-party professionals who are well-versed in the area. However, when applied appropriately, ASC 310-30 may allow institutions to reduce variability in earnings.

Institutions should expect their auditors and regulators to ask many questions on the topic of ASC 310-30, given its intricacies and complexities. Several accounting policy decisions must be made and some may be inherent in the accounting software chosen. Accordingly, comprehensive documentation is critical to support management's analysis and conclusions.



Institutions should expect their auditors and regulators to ask many questions on the topic of ASC 310-30, given its intricacies and complexities.

Grant Thornton is here to help

For these and any other questions you may encounter, you'll receive integrated service delivery from a team that consists of professionals from our Audit, Tax, Regulatory Compliance, Business Advisory, Information Technology and Valuation groups. We can help in a number of ways:

- Evaluate whether your institution meets the FDIC's qualifications to bid on a failed bank
- Evaluate the failed bank acquisition within the compressed FDIC due diligence period
- Decipher the relevant accounting and tax issues related to failed bank acquisitions
- Implement the processes and controls necessary for ongoing FDIC loss-sharing agreement reports
- Determine bid components
- Determine the fair value of assets acquired and liabilities assumed in the business combination
- Advise on accounting methods and policies
- Evaluate the impact of an acquisition on income tax positions, capital ratios and other key metrics

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For more information, contact:

Nichole Jordan
Partner and Sector Leader
Banking and Securities
T 214.561.2266
E Nichole.Jordan@gt.com

Tax
Tim Cleary
Executive Director – Tax
T 312.602.8176
E Tim.Cleary@gt.com

Accounting
Dorsey Baskin
Central Region Partner-in-Charge –
Professional Standards Group
T 214.561.2328
E Dorsey.Baskin@gt.com

George Mark
Partner and New York Financial
Institutions Practice Leader
T 212.624.5210
E George.Mark@gt.com

Greg Anglum
Partner – Financial Institutions and
Financial Services
T 919.881.2706
E Greg.Anglum@gt.com

Jamie Mayer
Senior Manager – Accounting
Principles Consulting Group
T 312.602.8766
E Jamie.Mayer@gt.com

Michael Gilreath
Senior Manager – Financial Services
T 704.632.6843
E Mike.Gilreath@gt.com

P. Graham Dyer
Manager – Financial Services
T 214.561.2264
E Phillip.Dyer@gt.com

Valuations
Edward Karstetter
Managing Director – Economic Advisory
Services
T 213.596.6762
E Edward.Karstetter@gt.com

Due diligence
Jerry Dentinger
Director – Transaction Advisory
Services
T 312.602.8262
E Jerry.Dentinger@gt.com

Mike Ryan
Audit Practice Leader
T 704.632.6793
E Mike.Ryan@gt.com

Systems integration
Jeffrey Spivack
Principal – Business Advisory Services
T 415.365.5434
E Jeffrey.Spivack@gt.com

Offices of Grant Thornton LLP

National Office

175 West Jackson Boulevard
Chicago, IL 60604
312.856.0200

National Tax Office

1900 M Street, NW, Suite 300
Washington, D.C. 20036
202.296.7800

Arizona

Phoenix 602.474.3400

California

Irvine 949.553.1600
Los Angeles 213.627.1717
Sacramento 916.449.3991
San Diego 858.704.8000
San Francisco 415.986.3900
San Jose 408.275.9000
Woodland Hills 818.936.5100

Colorado

Denver 303.813.4000

Florida

Fort Lauderdale 954.768.9900
Miami 305.341.8040
Orlando 407.481.5100
Tampa 813.229.7201

Georgia

Atlanta 404.330.2000

Hawaii

Honolulu 808.536.0066

Illinois

Chicago 312.856.0200
Oakbrook Terrace 630.873.2500

Kansas

Wichita 316.265.3231

Maryland

Baltimore 410.685.4000

Massachusetts

Boston 617.723.7900

Michigan

Detroit 248.262.1950

Minnesota

Minneapolis 612.332.0001

Missouri

Kansas City 816.412.2400
St. Louis 314.735.2200

Nevada

Reno 775.786.1520

New Jersey

Edison 732.516.5500

New Mexico

Albuquerque 505.855.7900

New York

Long Island 631.249.6001
Downtown 212.422.1000
Midtown 212.599.0100

North Carolina

Charlotte 704.632.3500
Greensboro 336.271.3900
Raleigh 919.881.2700

Ohio

Cincinnati 513.762.5000
Cleveland 216.771.1400

Oklahoma

Oklahoma City 405.218.2800
Tulsa 918.877.0800

Oregon

Portland 503.222.3562

Pennsylvania

Philadelphia 215.561.4200

South Carolina

Columbia 803.231.3100

Texas

Austin 512.391.6821

Dallas

Houston 214.561.2300
San Antonio 832.476.3600
210.881.1800

Utah

Salt Lake City 801.415.1000

Virginia

Alexandria 703.837.4400
McLean 703.847.7500

Washington

Seattle 206.623.1121

Washington, D.C.

Washington, D.C. 202.296.7800

Wisconsin

Appleton 920.968.6700
Madison 608.257.6761
Milwaukee 414.289.8200

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