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2023 Adopter CECL Implementation Road Map Series

Acquisition Accounting – Where the Rubber Meets the Road

May 25, 2023

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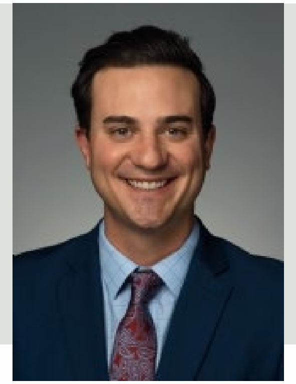
Meet the Presenters



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Agenda

- ASC 820 & ASC 805 Basics
- Topic 326 (CECL) Basics
- Dueling Credit Estimates
- Best Practices
- Breaking News

Background

Day 1

- Purchase Accounting Adjustments
- ASC 820 & ASC 805
- ASC 326 (PCD loans)

Day 1+1

- ACL for non-PCD loans immediately after Day 1
- ASC 326

Day 2

- Ongoing Accounting
- ASC 310-20 & ASC 326

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ASC 820 & 805 Basics

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Fair Value Definition

- ASC 820 defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”

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Market Participants

ASC 820 emphasizes fair value is determined based on a hypothetical transaction at the measurement date, considered from the perspective of a market participant

Buyers & sellers in the principal (or most advantageous) market

- Independent of the reporting entity
- Knowledgeable, having a reasonable understanding of the asset & transaction based on all available information, including information that might be obtained through due diligence efforts that are usual & customary
- Able to transact
- Willing to transact (motivated but not forced)

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Loan Fair Value

- Consists of a credit adjustment & a yield adjustment
- Used under fair value option, ASC 805, & ASU 2016-01 fair value disclosures

Topic 326 (CECL) Basics

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CECL Terminology

- Purchased assets with credit deterioration (PCD) as defined by management. For loans, generally considers
  - Delinquent loans as of the acquisition date
  - Downgraded loans since origination
  - Nonaccrual Loans
- Non-PCD Assets
  - Loans not classified as PCD, *i.e.*, everything else

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Accounting for Non-PCD Loans

- Under ASC 805 each acquired loan is marked to fair value with a credit adjustment & yield adjustment
- The combined fair value adjustment (often a discount in this current rate environment) is accreted over the remaining life of the loan under Day 2
- Separately, on Day 1+1 under ASC 326, an ACL is required to be recorded based on the loan's amortized cost basis, *i.e.*, fair value at acquisition date. This is separate from the credit component embedded in the loan's fair value
- The ACL on non-PCD loans is recorded as provision expense through the income statement

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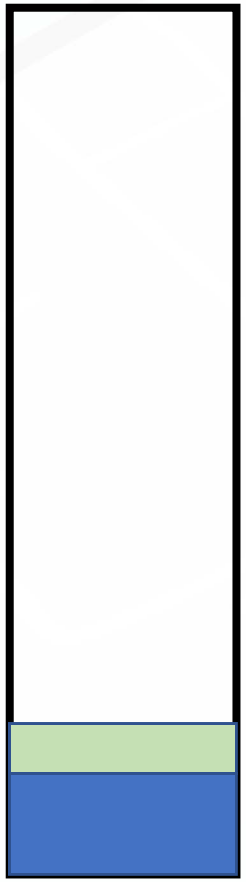
Application – Non-PCD Loans

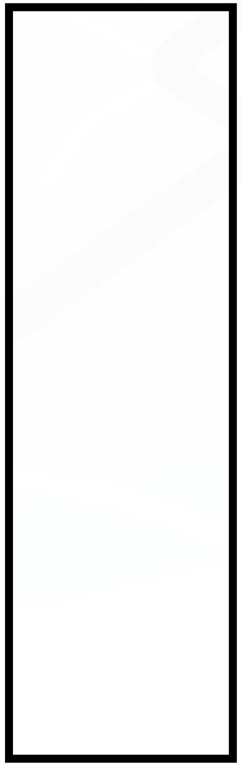
- Day 1



Principal Balance $100,000
Fair Value $98,500

Yield Mark -0.5% or $500
Credit Mark -1.0% or $1,000

- Day 1+1



Amortized Cost $98,500

ACL – ????

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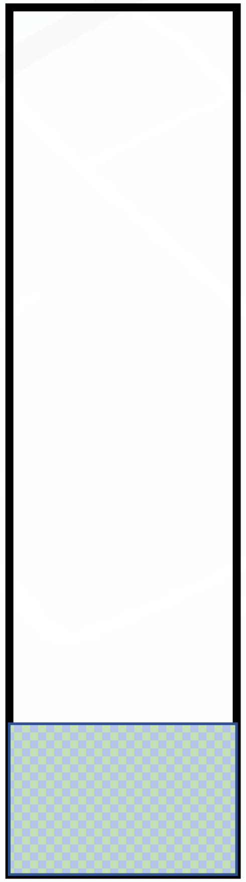
Application – Non-PCD Loans

- Day 2 (ASC 310)



Principal Balance	$100,000
Contra Account	$1,500
Carrying Value	$98,500

Combined discount is accretable over the life of the loan

Accretable Discount
1.5% or $1,500

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Accounting for PCD Loans

- Under ASC 805 each acquired loan is marked to fair value with a credit adjustment & yield adjustment
- Independent of fair value, management must estimate ACL on PCD loans based on *unpaid principal balance*
- The ACL is added to the purchase price (fair value) to determine the initial amortized cost basis
- Noncredit discount (the difference) is an accretable discount
- No immediate impact to income statement

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Wait, What!?!?!

- Yes, the ACL on PCD loans is required to be estimated for initial purchase accounting
- Therefore, two estimates of credit loss are used: ASC 805 fair value & ASC 326 ACL
- The evidence

> **Purchased Financial Assets with Credit Deterioration**

326-20-30-13 An entity shall record the allowance for credit losses for **purchased financial assets with credit deterioration** in accordance with paragraphs 326-20-30-2 through 30-10 and 326-20-30-12. An entity shall add the allowance for credit losses at the date of acquisition to the purchase price to determine the initial **amortized cost basis** for purchased financial assets with credit deterioration. Any noncredit discount or premium resulting from acquiring a pool of purchased financial assets with credit deterioration shall be allocated to each individual asset. At the acquisition date, the initial allowance for credit losses determined on a collective basis shall be allocated to individual assets to appropriately allocate any noncredit discount or premium.

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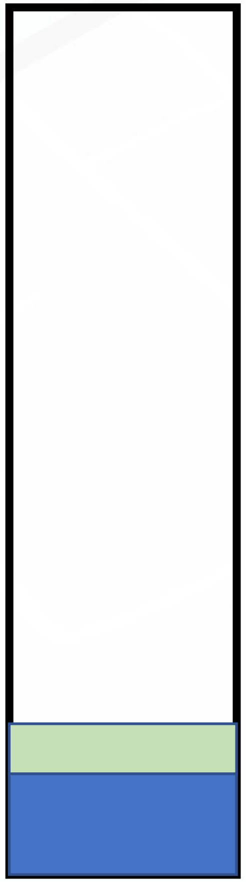
Application – PCD Loans

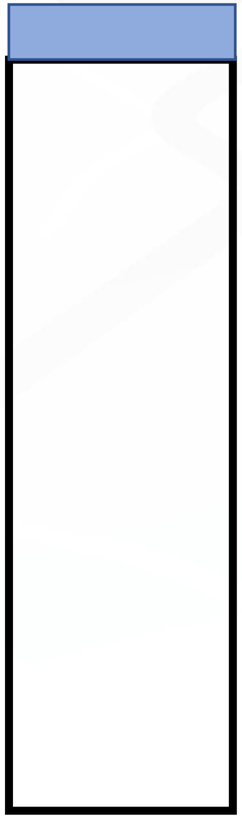
- Day 1 – Fair Value



Principal Balance $100,000
Fair Value $98,500

Yield Mark -0.5% or $500
Credit Mark -1.0% or $1,000

- Day 1 – CECL



ACL	$900
Amortized Cost	$99,400
Purchase Price	$98,500

In PCD accounting, “solve for” amortized cost

$98,500	+	$900	=	$99,400
Purchase Price based on FV		ACL on PCD loans		Amortized cost

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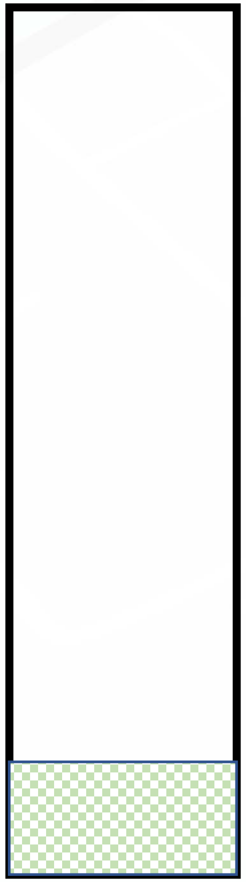
Application – PCD Loans

- Day 2 (ASC 310)



Principal Balance	$100,000
Contra Account	$600
Amortized Cost	$99,400

Accretable (Noncredit)
Discount $600

Difference between the amortized cost & principal balance is accretable over the life of the loan

Dueling Credit Estimates

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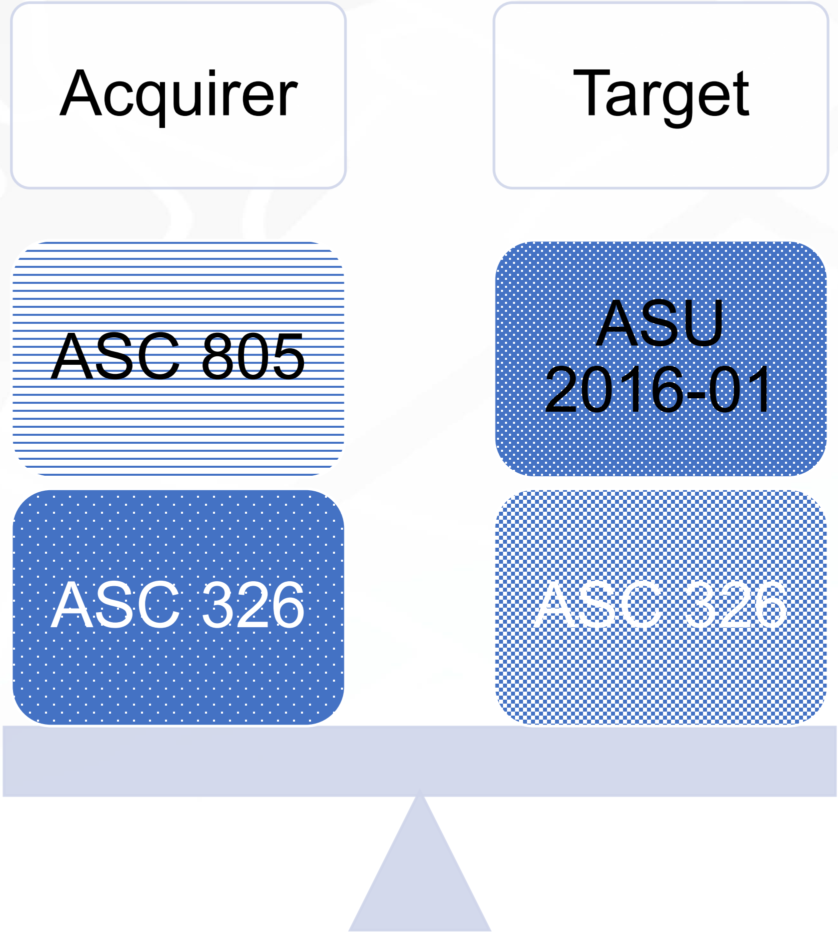
Credit Loss Measurement

- There are three (potentially four) measurements of credit loss on the same loan portfolio at a single point in time



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Credit Estimates Under ASC 805 vs. ASC 326

- *What happens when there is a **significant** difference between the credit estimate provided by the specialist & the acquiring bank's ACL calculation?*
- How does management get comfortable? What are the GAAP differences in 805 versus 326?

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ASC 820 vs. ASC 326 Credit Loss Estimates

Characteristic	ASC 820	ASC 326
Life of Loan	Yes	Yes
Market Participant	Yes	No
Exit Price	Yes	No
Entity Specific	No	Yes
Measurement Method	DCF	Multiple
Measurement Base	Principal Balance	Amortized Cost (non-PCD)
Measurement Approach	Individual &/or pooled *	Individual &/or pooled*

*Note

- Segmentation may differ
- Both include qualitative & quantitative estimates, but presented differently

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Perspective Differences

The same loan/loan portfolio may be viewed differently by buyers, sellers, or other market participants

- Loan rating
- Origination & credit administration practices
- Knowledge of borrowers
- Knowledge of geographic market
- Loan type
- Forecasts & other qualitative factors
- Overall comfort level with ACL coverage

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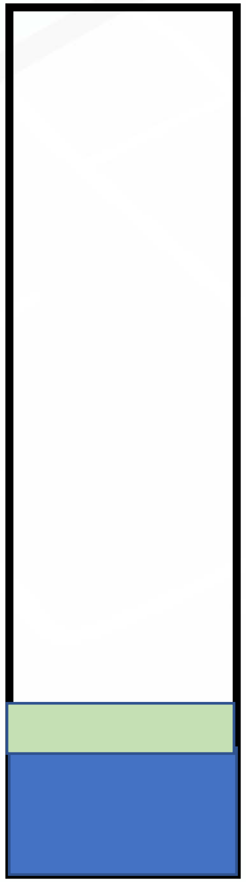
Application – PCD Loans *(ACL is less than Day 1 Credit Mark)*

- Day 1 – Fair Value

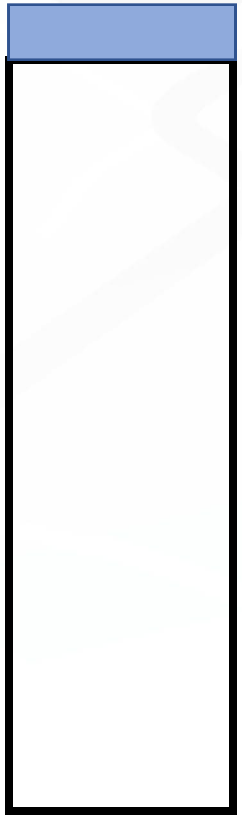


Principal Balance $100,000,000
Fair Value $97,500,000

Yield Mark -0.3% or $300,000

Credit Mark -2.2% or $2,200,000

- Day 1 – CECL



ACL	$500,000
Purchase Price	$98,500,000
Amortized Cost	$99,000,000

Does the $1.7 million difference between the credit mark & ACL create an issue?

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Addressing the Difference

- Addressing significant, *i.e.*, material, differences between credit loss estimates between ASC 805 & ASC 326 will likely be expected
- Documentation on
  - Inputs & assumptions used by specialist
  - Inputs & assumptions used in ACL calculation
  - Outlining inherent difference between market participant & exit price notions to ACL

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Best Practices

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Purchase Accounting Best Practices

- Develop an institution-specific PCD definition
- Apply this definition to acquired loans consistently
- If acquisitive, develop a consistent relationship with a valuation specialist
- Understand valuation specialist's inputs & assumptions
- Address credit estimate differences in preliminary calls with auditors & specialists
- Document any significant differences in credit estimates!

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Breaking News!

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Proposed Changes to ASC 326

- FASB is currently considering a potential change to acquired financial assets under ASC 326 by eliminating the distinction between PCD & non-PCD assets
- The proposed change would apply the PCD accounting model to most acquired assets & introduce a new term: purchased financial assets (PFA)
- An exposure draft is expected in Q2 2023

Financial Instruments—Credit Losses (Topic 326)—Acquired Financial Assets (fasb.org)

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Questions & Answers

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