Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
National Credit Union Administration
Office of Thrift Supervision

INTERAGENCY SUPERVISORY GUIDANCE ON BARGAIN PURCHASES AND FDIC- AND NCUA-ASSISTED ACQUISITIONS

June 7, 2010

I. Purpose

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of Thrift Supervision (OTS) (collectively, the agencies) are issuing guidance to address supervisory considerations related to bargain purchase gains and the impact such gains have on the application (licensing) approval process. This guidance also highlights the accounting and reporting requirements unique to business combinations resulting in bargain purchase gains and FDIC- and NCUA-assisted acquisitions of failed institutions (assisted acquisitions). Although this guidance principally focuses on bargain purchase gains, it is also relevant to business combinations in general. However, this guidance does not provide a comprehensive discussion on all aspects of accounting for business combinations.

This guidance does not add to or modify existing regulatory reporting requirements issued by the agencies or current accounting requirements under generally accepted accounting principles (GAAP). Institutions and examiners should refer to the relevant GAAP literature and regulatory reporting instructions for appropriate accounting and reporting guidance.[1] The principal sources of guidance on business combinations and related measurements under GAAP are Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 805, *Business Combinations*,[2] and ASC Topic 820, *Fair Value Measurements and Disclosures*.[3]

II. Background

Recent market conditions have contributed to an increase in bargain purchases. Although accounting literature indicates that bargain purchases are not expected to be common, certain acquisitions, particularly those involving FDIC or NCUA assistance, may result in

[1] See Appendices A and B for information regarding selected GAAP accounting and regulatory reporting requirements for business combinations, including those related to assisted acquisitions.
[2] Pre-codification reference: Statement of Financial Accounting Standards No. 141(R), *Business Combinations.*
[3] Pre-codification reference: Statement of Financial Accounting Standards No. 157, *Fair Value Measurements.*

a bargain purchase due to their nature, structure, and timing. In general, a bargain purchase occurs when the fair value of the net assets acquired in a business combination exceeds the fair value of the consideration transferred by the acquiring institution. However, for combinations of mutual institutions in which no consideration is transferred,[4] a bargain purchase occurs when the fair value of the net assets acquired exceeds the fair value of the equity or member interests in the acquiree. This excess, previously referred to as "negative goodwill," should be recognized immediately as a gain in earnings (bargain purchase gain), which increases GAAP equity.

In assisted acquisitions, the FDIC or the NCUA effectively administers an auction for certain assets and liabilities of a failing institution. In the FDIC's case, prior to failure, the distressed institution is marketed to potential acquirers on a pre-approved bidders' list during a limited due diligence period. As part of the acquisition, the FDIC frequently enters into a loss-sharing agreement[5] with the acquirer that indemnifies the acquirer for certain losses incurred on assets covered under the agreement (covered assets).

An acquiring institution should apply the acquisition method of accounting to all business combinations in accordance with ASC Topic 805. Accordingly, the acquiring institution should recognize and measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interests in the acquiree. The application of the acquisition method may result in the acquirer recognizing some assets and liabilities not previously recognized by the acquiree, such as an indemnification asset resulting from a loss-sharing agreement with the FDIC.[6] The acquiring institution should then recognize and measure either goodwill or a bargain purchase gain.

With limited exceptions, ASC Topic 805 requires all recognized assets acquired and liabilities assumed in a business combination to be measured at their acquisition-date fair values. Fair values should be measured in accordance with ASC Topic 820, which states that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date (an exit price). The quality of acquisition-date fair values is of critical importance because of their impact on the acquiring institution's post-acquisition earnings, GAAP equity, and regulatory capital.

At the acquisition date, the acquiring institution generally will not have obtained all of the information necessary to measure the fair values of the assets acquired and liabilities assumed in a business combination. This is particularly true in the acquisition of a failed institution where the acquiring institution can perform only limited due diligence prior to the acquisition date. Accordingly, when accounting for a business combination, the acquiring institution should initially record provisional amounts for the fair values of the

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[4] See ASC Paragraphs 805-30-55-3 through 55-5, *Special Considerations in Applying the Acquisition Method to Combinations of Mutual Entities*.

[5] Frequently asked questions and answers related to FDIC loss-sharing agreements may be accessed at: http://www.fdic.gov/bank/individual/failed/lossshare/index.html.

[6] An FDIC loss-sharing agreement may also affect the risk-based capital treatment for the guaranteed portion of the covered assets. Risk-weighted asset treatment for covered assets is more fully described in Appendix B.

assets acquired and liabilities assumed based on the best information available at the acquisition date. Management should then retrospectively adjust these provisional amounts to reflect new information obtained during the measurement period[7] about facts and circumstances that existed as of the acquisition date that, if known, would have affected the acquisition-date fair value measurements. Any retrospective adjustments to acquisition-date fair values will affect the provisional amount of goodwill or bargain purchase gain recognized in a business combination.[8]

III. Supervisory Considerations

Compliance With GAAP and Regulatory Reporting Requirements

Accurate regulatory reports are critical for effective supervision and, because of their public availability, for enhancing the transparency of an institution's risk profile and financial position. As stated previously, business combinations, including bargain purchase transactions and assisted transactions, should be accounted for in accordance with ASC Topic 805. The management of an acquiring institution is responsible for preparing regulatory reports in accordance with GAAP, regulatory reporting requirements, and relevant supervisory guidance. The complexity of the accounting requirements related to a business combination does not relieve management of this responsibility and should be factored into management's overall analysis of the practicability of a potential acquisition. The management of each institution is responsible for establishing and maintaining appropriate governance and an effective internal control structure over the preparation of regulatory reports commensurate with the institution's size, complexity, and risk profile. This structure should include written policies and procedures that provide clear guidelines on accounting and reporting matters related to business combinations.

The agencies encourage management to discuss applicable regulatory reporting requirements and supervisory considerations with its primary federal regulator prior to consummating a business combination.

[7] In accordance with ASC Topic 805, the measurement period is the period of time after the acquisition date, not to exceed 12 months, that is required to identify and measure the fair value of the identifiable assets acquired, the liabilities assumed, and any noncontrolling interests in the acquiree in a business combination. The measurement period ends as soon as the acquiring institution receives the information it was seeking about facts and circumstances that existed as of the acquisition-date or learns that more information is not obtainable.

[8] When retrospective adjustments are made to provisional amounts during the measurement period, ASC Topic 805 requires an acquiring institution to revise comparative information for prior periods presented in financial statements as needed as if the accounting for the business combination had been completed at the acquisition date. The agencies' regulatory reports do not present comparative information. Accordingly, an institution is not required to amend previously filed regulatory reports for retrospective adjustments made to provisional amounts during the measurement period.

Fair Value Measurements

The valuation of the assets acquired and liabilities assumed in a business combination presents accounting and supervisory challenges. For example, many of these assets and liabilities are illiquid and lack quoted market prices, which complicates the estimation of their acquisition-date fair values. Thus, a key issue underlying fair value estimates is the appropriateness of inputs and the appropriate selection and use of valuation techniques. Some valuation techniques employ complex models and, therefore, warrant further supervisory review. For example, reliability concerns may arise when the institution does not use clear and rigorous valuation techniques or where one or more significant inputs to a valuation estimate are not observable, even indirectly, from active markets. This is especially true when estimating the fair value of illiquid financial instruments, indemnification assets, and identifiable intangible assets that are acquired in a business combination.

It is management's responsibility to report fair values in accordance with ASC Topic 820. Because of the significant impact fair value measurements and any resultant goodwill or bargain purchase gain have on the financial statements, management should have appropriate written fair value measurement policies, procedures, and controls in place. These policies, procedures, and controls should be executed by experienced and qualified individuals knowledgeable in both GAAP and regulatory reporting requirements for business combinations. Furthermore, management's fair value measurements should be well supported and are subject to review by examiners.

If management does not possess the expertise to identify and measure the identifiable assets acquired and the liabilities assumed in a business combination (and the equity or member interests in the acquiree in a combination of mutual institutions), management should engage a qualified third party expert to provide professional guidance and support for the preparation of fair value measurements required by ASC Topic 805 and determined in accordance with ASC Topic 820. For example, management may use a third party to estimate the expected cash flows and the fair value of a loan portfolio acquired in an assisted acquisition (and the related expected cash flows and fair value of an FDIC loss-sharing indemnification asset). The use of outside resources, however, does not relieve management of its responsibility to ensure that fair value estimates are measured in accordance with GAAP. Management must sufficiently understand the bases for the measurement and valuation techniques used by outside parties to determine the appropriateness of these techniques, the underlying inputs and assumptions, and the resulting fair value measurements.

Retrospective Adjustments of Fair Value Measurements During the Measurement Period

During the measurement period, management should finalize its fair value measurement estimates and retrospectively adjust the provisionally recorded amounts to reflect the information it was seeking about the acquisition-date facts and circumstances promptly after receipt of this information. The existence of a measurement period does not permit

management to delay completion of comprehensive fair value measurements that conform to the requirements of ASC Topic 820. Rather, at the earliest possible reporting date, management should establish and report appropriate fair value estimates for the identifiable assets acquired and liabilities assumed in a business combination (and the equity or member interests in the acquiree in a combination of mutual institutions).

An acquiring institution's regulatory capital is subject to retrospective adjustments made during the measurement period. Although bargain purchase gains are reported in earnings and included in the computation of regulatory capital under the agencies' capital standards, the acquiring institution's primary federal regulator may determine an estimated bargain purchase gain lacks sufficient necessary permanence to rely on the estimate as a component of regulatory capital. Therefore, as discussed in Section IV, supervisory and application (licensing) conditions may be imposed on the acquiring institution. When imposed, these conditions normally would be in place until the measurement period for accounting purposes has ended and management's fair value estimates and the related bargain purchase gain have been validated through an independent external audit (or agreed-upon procedures engagement) or examiner review. This time frame is hereafter referred to as the "conditional period."

IV. Application (Licensing) Considerations

Business Combination Applications

An institution that is considering acquiring another institution or otherwise engaging in a business combination should submit the appropriate application to its primary federal regulator and any appropriate state regulator for approval prior to consummating the transaction. To facilitate the application review process, the agencies encourage an acquirer to submit a transparent and well-documented application.[9]

The fair value estimates presented in a business combination application are generally preliminary and any estimated bargain purchase gain may not be reliable for purposes of evaluating the adequacy of the acquiring institution's acquisition-date pro forma regulatory capital. Because of this uncertainty, the acquiring institution's primary federal regulator will review the significance of any gain expected to be recognized from a bargain purchase (for example, relative to the pro forma capital structure of the acquiring institution) when evaluating the institution's application.

To facilitate this review of the pro forma capital calculations,[10] an acquiring institution is encouraged to include one pro forma balance sheet with two sets of pro forma capital

[9] The guidance in this Section IV, including the discussion of conditions, also applies to any notice that an institution must submit to a federal banking agency for non-objection or to the NCUA related to a federally-insured state-chartered credit union approval in connection with a proposed business combination and to any action the FDIC or the NCUA must take with respect to an institution's acquisition of a failing FDIC- or National Credit Union Share Insurance Fund-insured institution.
[10] Pro forma financial information is required to be submitted as part of the Interagency Bank Merger Act Application (OCC OMB No. 1557-0014, FRB OMB No. 7100-0171, FDIC OMB No. 3064-0015, and OTS OMB No. 1550-0016) and Bank Holding Company Act filings.

calculations in any application requesting approval of a business combination that results in a bargain purchase. The first set of pro forma capital calculations should be prepared based on applicable regulatory capital guidelines; therefore, any preliminary estimate of the gain from a bargain purchase should be included in the estimated pro forma regulatory capital. The second set of estimated pro forma capital calculations should eliminate from pro forma regulatory capital (1) any bargain purchase gain expected to be recognized in the proposed business combination and (2) any bargain purchase gains from prior business combinations for which the conditional period has not yet ended. The second set of estimated pro forma regulatory capital calculations is necessary for application and supervisory decision-making purposes to illustrate the potential impact on regulatory capital if the preliminary estimate of the bargain purchase gain is not ultimately confirmed.[11]

Conditions Imposed in Approvals

Because of concerns about the quality and composition of capital when a bargain purchase gain is expected to result from a business combination and the related fair value estimates have not yet been validated, the agencies may impose certain conditions in their approvals of acquisitions of institutions to maintain and protect the safety and soundness of the acquiring institutions. Conditions may include, but are not limited to, the following:

Capital Preservation
Consistent with the agencies' existing authorities, an acquiring institution's primary federal regulator may require the institution to hold capital in excess of regulatory minimums in an amount commensurate with its asset quality and overall risk profile. Thus, the acquiring institution's primary federal regulator may approve an acquisition provided the institution (or its parent company in the case of a holding company structure) commits to a capital preservation plan that requires it to maintain specified levels of capital to address the risk of significant retrospective adjustments to the bargain purchase gain or other risks that may adversely affect capital levels.

Dividend Limitations
The acquiring institution's primary federal regulator may approve an application in which the institution's pro forma capital includes an expected gain from a bargain purchase on the condition that the institution excludes the gain from its dividend-paying capacity calculation until the end of the conditional period.[12] Such a condition would address supervisory concerns that could negatively affect the safety and soundness of the acquirer.

[11] Institutions should follow GAAP, regulatory reporting instructions, and regulatory capital standards when calculating regulatory capital for regulatory reporting purposes. Pro forma regulatory capital calculations that eliminate a bargain purchase gain are only applicable for application purposes.
[12] In this context, the term "dividend" means a distribution from the retained earnings of a bank or savings association with a stock form of ownership to its stockholders rather than an interest payment on a deposit account to a credit union member. Within the credit union industry, "dividend on a share account" is analogous to "interest on a bank deposit account." Dividend limitations are not directed to interest or dividend payments on deposit or share accounts.

Independent Audits or Agreed-Upon Procedures Engagements
An agency may also require, as a condition of its approval, that an acquiring institution not subject to an annual audit requirement[13] obtain an independent audit of its financial statements for the year in which a business combination occurs (and the subsequent year, if the measurement period is expected to continue into that year).[14] Alternatively, the agency may require an acquiring institution to engage an independent public accountant to perform agreed-upon procedures on elements, accounts, or items in the acquiring institution's financial statements relating to its accounting for the business combination in accordance with GAAP. The agency's approval may specify that the independent public accountant selected by the acquiring institution be acceptable to the agency and that the agency be granted access to the accountant's workpapers for the engagement.

Independent Valuations
If the acquiring institution does not possess the internal expertise and/or the institution has not already engaged a qualified expert, an agency may require, as a condition of its approval, that the acquirer obtain independent valuations from a reputable and experienced third party valuation expert deemed acceptable to the agency for some or all of the identifiable assets acquired and liabilities assumed. This condition may require the acquiring institution to provide analyses on completed valuations, including comparisons to the initial provisional fair value amounts, to its primary federal regulator until the end of the conditional period for purposes of monitoring the impact of significant changes in these values on financial reporting and regulatory capital. In addition, examiners may review the measurement process, including the reasonableness of the valuation inputs and assumptions, and the valuation techniques used in these fair value measurements, as part of their ongoing supervisory activities.

Legal Lending Limit
A gain from a bargain purchase increases an institution's capital, which increases its legal lending limit. To promote the safety and soundness of acquiring institutions and after considering all the facts and circumstances of a bargain purchase, the acquiring institution's primary federal regulator may require, as a condition in its approval, the institution to exclude any bargain purchase gain from the calculation of its legal lending limit until the end of the conditional period.

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[13] For example, Part 363 of the FDIC's regulations and Sections 715.5(a) and 715.6(a) of the NCUA's regulations require federally insured institutions with $500 million or more in total assets as of the beginning of their fiscal year to engage an independent public accountant to audit their financial statements. Section 562.4 of the OTS's regulations includes additional audit requirements.
[14] If the acquiring institution is a subsidiary of a holding company, an independent audit of the holding company's consolidated financial statements may be acceptable in lieu of an audit of the acquiring institution when the business combination and any bargain purchase gain are material in relation to the consolidated financial statements.

APPENDIX A

SELECTED ACCOUNTING CONSIDERATIONS FOR BUSINESS COMBINATIONS

This appendix reiterates key concepts and requirements that are included in GAAP applicable to business combinations, but it does not provide a comprehensive guide on all aspects of accounting for business combinations. The principal sources of guidance on business combinations and related measurements under GAAP are Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 805, *Business Combinations*, and ASC Topic 820, *Fair Value Measurements and Disclosures*. Institutions are expected to apply these standards as well as the guidance in this issuance when preparing Consolidated Reports of Condition and Income (Call Reports), Thrift Financial Reports (TFRs), and NCUA Call Reports (5300s).

ASC Topic 805 requires the application of the acquisition method to all business combinations, including assisted acquisitions. The acquisition method entails: (1) identifying the acquirer; (2) determining the acquisition date; (3) recognizing and measuring the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree; and (4) recognizing and measuring goodwill or a gain from a bargain purchase. Generally, these steps require the exercise of significant judgment.

Recognizing and Measuring the Identifiable Assets Acquired and Liabilities Assumed

Assets with Uncertain Cash Flows

An acquiring institution is not permitted to recognize an allowance for loan and lease losses (ALLL) for acquired held-for-investment loans at the acquisition date.[15] Rather, as discussed below, cash flow uncertainty should be considered in the fair value measurement of the acquired loans. If the fair value option is not elected, purchased, impaired loans should be accounted for in accordance with ASC Subtopic 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*,[16] which requires income recognition based on expected cash flows.[17] If the fair value option is not elected, purchased non-impaired loans should be accounted for in a manner consistent with ASC Subtopic 310-20, *Nonrefundable Fees and Other Costs*,[18] which requires income

[15] The acquiring institution should establish loan loss allowances for acquired held-for-investment loans in periods after acquisition for losses incurred on these loans due to credit deterioration after acquisition.

[16] Pre-codification reference: American Institute of Certified Public Accountants (AICPA) Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3).

[17] For additional guidance and examples on accounting for purchased impaired loans in accordance with ASC 310-30 (formerly SOP 03-3), see FDIC Supervisory Insights: Implications of New Guidance on Accounting for Purchased Impaired Loans, which is available at www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/accounting_news.html.

[18] Pre-codification reference: Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.*

recognition based on contractual cash flows, unless an expected cash flow accounting policy election is made.[19]

An acquiring institution should use judgment in determining the most appropriate accounting for loans acquired at a discount and not assume loans purchased at a discount are automatically included in or excluded from the scope of ASC Subtopic 310-30. For an acquired loan to be considered within the scope of ASC Subtopic 310-30 there must be evidence of deterioration of credit quality in the loan since origination and it must be probable, at acquisition, that the acquiring institution will be unable to collect all contractually required payments. [20] The acquiring institution should establish policies, including reasonable thresholds, based on the type of loan product to determine whether a loan is within the scope of ASC Subtopic 310-30. For example, it may be appropriate for the acquiring institution to use the previous institution's record of changes in credit grades and accrual status for commercial loans, which are generally evaluated individually on an ongoing basis, to determine whether the loan has experienced deterioration in credit quality since origination. For consumer loans, an acquiring institution may use other indicators to determine whether there has been deterioration in credit quality since origination, including, but not limited to, nonaccrual status, past due status, or credit score changes since these loans generally are not individually evaluated for impairment.

Indemnification Asset

Expected cash flows underlying the acquisition-date fair value of loans and other financial assets covered by FDIC loss-sharing agreements should reflect only cash flows expected to be collected from the borrower using market participant assumptions. Covered other real estate owned should be recorded at the acquisition date at fair value less cost to sell. The acquirer should recognize a separate asset for cash flows expected to be collected from the FDIC as reimbursement for losses incurred on covered assets.

In the absence of specific guidance issued by accounting standard setters for assisted acquisitions involving loss-sharing agreements, an institution may elect to report the FDIC loss-sharing agreement at fair value with changes in fair value recognized in current earnings (e.g., the fair value option)[21] or, alternatively, may elect an accounting treatment based on the guidance for indemnification assets in ASC Topic 805. If

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[19] In a letter dated December 18, 2009, from the chair of the AICPA Depository Institutions Expert Panel to the Securities and Exchange Commission (SEC) staff, the AICPA summarized a discussion between the AICPA and the SEC staff related to the accounting in subsequent periods for discount accretion associated with loan receivables acquired in a business combination or asset purchase. The letter (www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/DownloadableDocuments/Confirmation-letter-on-Day-2.pdf) states the SEC staff would not object to an accounting policy based on contractual cash flows or an accounting policy based on expected cash flows for all such acquired loans. In the absence of other authoritative guidance, the agencies do not object to the SEC staff's position. Potential acquirers should be alert for any updated authoritative guidance related to this topic.

[20] Additional scope considerations are discussed in ASC Section 310-30-15.

[21] See ASC Topic 825, *Financial Instruments*, for further discussion of the fair value option. ASC Topic 815, *Derivatives and Hedging*, also discusses arrangements accounted for as derivative instruments, which may be applied to FDIC loss-sharing agreements.

accounted for as an indemnification asset, the acquiring institution should recognize an indemnification asset related to the covered assets and initially measure it in a manner consistent with (mirror) the corresponding covered assets. Accordingly, the indemnification asset related to covered assets should be reported at its acquisition date fair value.

Loss-sharing agreements typically cover the loss of principal, the loss of accrued interest not to exceed 90 days, and costs to sell other real estate owned. Only losses covered under the loss-sharing agreement should be incorporated into the fair value measurement of the indemnification asset. This asset is a component of the aggregate identifiable assets acquired and, therefore, its fair value will affect the amount of goodwill or gain from a bargain purchase recognized in an acquisition of a failed institution.

Under the approach described in Topic 805, subsequent to the acquisition date the indemnification asset should be assessed for impairment and measured on the same basis as (mirror) the covered assets. Any difference between the cash flows expected to be collected in accordance with the terms of the FDIC loss-sharing agreement and the fair value of the indemnification asset should generally be accreted and recognized in earnings over the term of the FDIC loss-sharing agreement. Subsequently measuring an indemnification asset on the same basis as the indemnified item has an effect of reducing earnings volatility that could otherwise arise if there were a mismatch in the measurement approach for the indemnification asset and the assets indemnified by the FDIC under the loss-sharing agreement. Differences between the actual and expected cash flows realized from the covered assets and changes in the expected future cash flows from the covered assets will affect the expected future cash flows from, and the subsequent accounting for, the indemnification asset. When an acquiring institution receives payments from the FDIC under a loss-sharing agreement for losses on covered assets, the payments should be credited to (reduce the carrying amount of) the indemnification asset. The payments should not be credited to the covered assets.

Fair Value Estimates

By their nature, assisted acquisitions have characteristics of distressed sales because the assets being sold and the liabilities being transferred by the FDIC or the NCUA are normally in receivership or liquidation and transactions are often completed quickly and with limited acquisition diligence. Since a fair value measurement in accordance with ASC Topic 820 assumes that the asset or liability is exchanged in an orderly transaction (i.e., a transaction that assumes exposure to the market for a period prior to the acquisition date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities), the amount that an acquiring institution bids to acquire assets and assume liabilities of the failed institution may not represent the fair value of these items in accordance with ASC Topic 820. In the absence of quoted market prices in active markets for identical assets and liabilities, an acquiring institution should use a valuation technique for measuring the fair values of assets acquired and liabilities assumed in a business combination. The inputs used in the valuation technique should be consistent with those that market participants would use to price these assets and liabilities. An institution’s estimate of fair value should reflect all the assumptions

that market participants would consider when determining the price it would receive to sell an asset or pay to transfer a liability in an orderly transaction at the acquisition date.

For example, the fair value of loans acquired in a business combination is generally estimated using a present value technique. The present value technique for acquired loans should incorporate the following elements from the perspective of market participants as of the acquisition date: (1) an estimate of future cash flows, (2) expectations about possible variations in the amount and/or timing of cash flows, (3) the time value of money, (4) the price for bearing the uncertainty inherent in the cash flows (i.e., a risk premium), and (5) other case-specific factors considered by market participants in the fair value measurement. Although present value techniques will differ in how these elements are incorporated into a fair value measurement, certain general principles, as discussed in ASC Topic 820, govern the application of any present value technique.

In addition, in an assisted acquisition, the deposit premium included in the acquiring institution's bid for a failing institution is not determinative of the acquisition-date fair value of the core deposit intangible that normally is one of the identifiable assets acquired in the transaction. The core deposit intangible arises from the failed institution's base of stable, low-cost deposit accounts (excluding time deposits), which provides a benefit to the acquiring institution. The fair value of the core deposit intangible acquired in a business combination is typically estimated using a present value technique. The future cash flows used in the valuation normally represent the cost savings resulting from a comparison of the overall cost of the core deposits and the overall cost of an alternative funding source over the period the acquired core deposits are expected to be retained.

The process and inputs for estimating fair values should be clearly documented. In all cases, the assumptions and resulting valuations should reflect current market conditions at the acquisition date, not at a later date during the measurement period. Additionally, all fair value estimates should be properly documented, supported, verifiable, and consistent with GAAP.

Recognizing and Measuring a Gain From a Bargain Purchase

Before recognizing a gain on a bargain purchase, ASC Topic 805 requires the acquirer to reassess whether it has correctly identified all of the assets acquired and liabilities assumed (and the equity or member interests in the acquiree in a combination of mutual institutions) and to recognize any additional assets or liabilities that are identified in that review. The acquirer should then review the procedures used to measure the amounts (generally, fair values) required to be recognized as of the acquisition date. If a gain exists after all reassessments, the acquirer should recognize a gain from a bargain purchase in earnings as of the acquisition date.

APPENDIX B

REGULATORY REPORTING REQUIREMENTS ASSOCIATED WITH BUSINESS COMBINATIONS

This appendix provides information concerning certain regulatory reporting considerations relevant to business combinations for preparing Consolidated Reports of Condition and Income (Call Reports), Thrift Financial Reports (TFRs), and NCUA Call Reports (5300s). The information provided in this appendix is current as of the issuance date of this guidance. The management of acquiring institutions should be alert for any updates to these regulatory requirements and is responsible for filing regulatory reports in accordance with the requirements in effect as of the filing date.

Call Report Requirements for Banks

Nonaccrual Status of Purchased Impaired Loans
ASC Subtopic 310-30 does not prohibit placing (or keeping) purchased impaired loans in nonaccrual status. At inception or thereafter, the institution may place a purchased impaired loan on nonaccrual if it does not have a reasonable expectation about the timing and amount of cash flows to be collected.

Delinquency Status of Purchased Loans
The delinquency status of purchased loans and other purchased financial assets must be determined in accordance with the contractual repayment terms for purposes of reporting on Schedule RC-N, Past Due and Nonaccrual Loans, Leases, and Other Assets. The delinquent loan should be reported at its recorded amount and not at its contractual balance due.

Goodwill and Bargain Purchase Gains
Any goodwill recognized in a business combination should be reported on Schedule RC, Balance Sheet, item 10.a, and must be deducted from Tier 1 capital in item 7.a of Schedule RC-R, Regulatory Capital. Any impairment losses on goodwill should be reported in Schedule RI, Income Statement, item 7.c.(1).

Any gain from a bargain purchase recognized in a business combination (before any tax effect[22]) should be included in Schedule RI, item 5.l, "Other noninterest income," which increases retained earnings as reported in Schedule RC, item 26.a. In addition, if the amount of this component of "Other noninterest income" is greater than $25,000 and exceeds 3 percent of the amount reported in Schedule RI, item 5.l, it should also be disclosed in Schedule RI-E, Explanations, item 1.h. As a component of retained earnings,

[22] Applicable income tax expense related to a bargain purchase gain should be included in Schedule RI, item 9.

bargain purchase gains are included in total bank equity capital in Schedule RC-R, item 1.[23]

Risk-Weighted Assets
Loss-sharing agreements entered into by the FDIC with acquirers of assets from failed institutions are considered conditional guarantees for risk-based capital purposes based on the contractual conditions that acquirers must meet. The guaranteed portion of assets subject to a loss-sharing agreement may be assigned a 20 percent risk weight. In addition, the indemnification asset related to the FDIC loss-sharing agreement should also be assigned a 20 percent risk weight. Because the structural arrangements for these agreements vary depending on the specific terms of each agreement, institutions should consult with their primary federal regulator to determine the appropriate risk-based capital treatment for specific loss-sharing agreements.

Additional Disclosures
The following additional disclosures related to business combinations are required in the Call Report:

- The balance sheet amount of loans and leases, other real estate owned, debt securities, and other assets covered by FDIC loss-sharing agreements should be reported in Schedule RC-M, Memoranda, items 13.a through 13.d.
- FDIC loss-sharing indemnification assets should included in Schedule RC-F, Other Assets, item 6, "All other assets." If the amount of this component of "All other assets" is greater than $25,000 and exceeds 25 percent of the amount reported in item 6, it should also be disclosed in Schedule RC-F, item 6.e.
- The outstanding balance and the carrying amount of purchased impaired loans subject to the guidance in ASC Subtopic 310-30 should be reported in Schedule RC-C, Part I, Loans and Leases, Memorandum items 7.a and 7.b, respectively, and the amount of allowance for post-acquisition losses on such loans should be reported in Schedule RI-B, Part II, Changes in Allowance for Loan and Lease Losses, Memorandum item 4.
- The fair value, the gross contractual amounts receivable, and the best estimate of contractual cash flows not expected to be collected, all as of the acquisition date, for purchased nonimpaired loans (i.e., purchased loans not subject to ASC Subtopic 310-30) should be reported in Schedule RC-C, Part I, Memorandum items 12.a through 12.d, during the year of the acquisition.
- The recorded amount and guaranteed portion of past due and nonaccrual covered loans and leases should be included in Schedule RC-N, items 10 and 10.a. Past due and nonaccrual covered loans and leases should also be reported by loan category in Schedule RC-N, items 1 through 8.
- Identifiable intangible assets acquired in a business combination, such as core deposit intangibles, should be reported in Schedule RC, item 10.b, and by type of intangible in Schedule RC-M, item 2. Identifiable intangible assets that are disallowed for regulatory capital purposes should be reported in Schedule RC-R, items 7.a and 9.a,

[23] An institution should eliminate the impact of gains from bargain purchases from its total equity capital only when submitting pro forma capital calculations in a business combination application as discussed in Section IV. Application (Licensing) Considerations.

as appropriate. Amortization expense and any impairment losses on certain identifiable intangible assets should be reported in the income statement in Schedule RI, item 7.c.(2).

TFR Requirements for Savings Associations

Intangible Assets (Including Goodwill)
Report most intangible assets (including goodwill) recognized in a business combination on Schedule SC – Consolidated Statement of Condition, line SC660. For purposes of computing Tier 1 (core) capital, deduct these assets on Schedule CCR – Consolidated Capital Requirement, line CCR115. A gain from a bargain purchase is not disallowed for purposes of computing Tier 1 (core) capital.

Covered Assets
The balance sheet amount of loans and leases, real estate owned, debt securities, and other assets covered by FDIC loss-sharing agreements should be reported in Schedule SI – Consolidated Supplemental Information, lines SI770, SI772, SI774, and SI776. Risk-weight the guaranteed portion of the assets subject to loss-sharing agreements at 20 percent, and accordingly report such assets on Schedule CCR, line 450, "Other."

FDIC Loss-Sharing Indemnification Assets
Report FDIC loss-sharing indemnification assets on Schedule SC, line SC689. Risk-weight such assets at 20 percent, and accordingly report such assets on Schedule CCR, line CCR450, "Other."[24]

Bargain Purchase Gains
Report bargain purchase gains as Other Noninterest Income on Schedule SO – Consolidated Statement of Operations, line SO488.

Schedule VA- Consolidated Valuation Allowances and Related Data
- Report purchased loans whose terms have been modified in a troubled debt restructuring on Schedule VA, lines VA940 and VA942.
- Report all purchased impaired loans on Schedule VA, lines VA980, VA981, and VA985.

Schedule PD – Consolidated Past Due and Nonaccrual
- *Delinquency status*: For purposes of reporting on Schedule PD, lines PD115 through PD380, determine the delinquency status of purchased loans (including purchased impaired loans) and other purchased financial assets in accordance with the contractual repayment terms. Report a delinquent loan at its recorded investment after deducting specific valuation allowances, not at its contractual balance due.

[24] The TFR Line CCR 409, "Notes and Obligations of FDIC, Including Covered Assets," which is assigned a zero percent risk-weight, is used for items unconditionally guaranteed by the U.S. government, not for conditional guarantees such as FDIC loss-sharing agreements covering assets acquired in assisted acquisitions.

- *Nonaccrual status:* GAAP (ASC Subtopic 310-30) does not prohibit placing (or keeping) purchased impaired loans on nonaccrual. At inception or thereafter, the association may place a purchased impaired loan on nonaccrual if it is does not have a reasonable expectation about the timing and amount of cash flows to be collected. Reflect this treatment when reporting purchased impaired loans on Schedule PD.
- *Government-guaranteed:* For loans and leases that are both (a) covered by FDIC loss-sharing agreements, and (b) reported as delinquent loans on Schedule PD, lines PD115 through PD380, also report these loans and leases as government-guaranteed loans and leases on Schedule PD, lines PD195, PD295, and PD395.

Schedule CCR – Consolidated Capital Requirement

- For all purchased loans and other purchased assets, including covered assets, but excluding FDIC loss-sharing indemnification assets, assign a risk-weighting consistent with the asset's inherent risk and classification, and report on Schedule CCR accordingly. The guaranteed portion of assets subject to a FDIC loss-sharing agreement may be assigned a 20 percent risk weight.

5300 Requirements for Credit Unions

There are special considerations to regulatory capital reporting for credit unions involved in mutual to mutual combinations in the reporting periods following a business combination. Through a recent statutory change to the regulatory capital definition, the acquirer may not include any equity acquired in a business combination ("acquired equity") as regulatory capital but may include an amount equal to the acquiree's acquisition-date retained earnings as measured in accordance with GAAP. Acquiring credit unions should review the related final rule to gain a full understanding of the post-acquisition regulatory capital implications.[25] On the 5300 in the case of involuntary, regulatory-assisted mutual to mutual credit union combinations, the acquiree's acquisition-date regulatory capital flowing forward to the acquirer would be zero but a gain on bargain purchase, if any, would qualify as regulatory capital. Acquired equity generated as a result of a mutual to mutual business combination including any goodwill inherent in that measure is part of GAAP equity, but not part of regulatory capital.

Goodwill and Bargain Purchase Gains

Any goodwill recognized in a business combination is recorded on Line 29.b of the Statement of Financial Condition. Any gain recognized from a bargain purchase should be reported on line 16 of the Statement of Income/Expense.

Delinquency Status of Purchased Loans and Other Financial Assets

The delinquency status of purchased loans and other purchased financial assets must be determined in accordance with the contractual repayment terms for the purposes of reporting on delinquency schedule of the 5300. The delinquent loan should be reported at its recorded amount and not at its contractual balance due.

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[25] Prompt Corrective Action: Amended Definition of Post-Merger Net Worth, http://www.ncua.gov/Resources/RegulationsOpinionsLaws/proposed_regs/Prompt%20Corrective%20Action%20Amended%20Definition%20of%20Post%20Merger%20Net%20Worth.pdf.

Nonaccrual Status of Purchased Impaired Loans
Normal nonaccrual parameters apply to purchased impaired loans.