Mergers in the 21st Century – Accounting and Operational Issues You Need to Know

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Presentation Objectives

- Provide insight on current accounting rules related to business combinations
- Identify specific regulatory issues related to credit union business combinations
- Provide guidance on key operational issues to consider before, during and after a business combination
- Share some of the “lessons learned” from the First Tech/Addison Avenue merger
Why Consider a Merger?

- Industry consolidation
- Geographic diversification of risk
- Weak financial performance
- Operating efficiencies via scale translates into member value:
  - Pricing of products and services
  - Capital for infrastructure and expansion
Common Reasons Mergers Fail

• Primary focus on getting bigger
• Partner not a good strategic fit
• Different cultural values
• Different vision of member service/value
• Poor communication re: retaining officials
• Uncertainty re: retention of staff
• Significant differences exist in compensation and employee benefits
Merger Accounting - Highlights

**Background:**

- Until December 31, 2008, the *pooling-of-interests* method of accounting was generally used by credit unions in business combinations.

- For all credit union business combinations taking place in fiscal years ending after December 15, 2008, the *acquisition method* of accounting was required.

- ASC 805 [formerly FAS 141(R)] is the authoritative guidance on accounting for business combinations.
Merger Accounting - Highlights

• Under ASC 805:
  • The two credit unions must determine which is the **acquirer** in the transaction
  • The **acquiring credit union** can usually be determined based on the following criteria:
    - Number of Board seats after merger
    - Composition of senior management
    - Comparative size of two credit unions
Merger Accounting - Highlights

• Under ASC 805:
  • The assets acquired and liabilities assumed from the target credit union must be recorded at fair value – includes loans, investments, property and equipment, member deposits, etc.
  • An entity value of the target credit union must be determined, separate from the individual assets and liabilities – typically based on recent sales of local community banks
Merger Accounting - Highlights

• Under ASC 805:
  • Previously unrecorded assets, such as goodwill and the core deposit intangible (CDI) must be recorded at fair value
  • Positive goodwill will equal the excess of (liabilities assumed at fair value plus the entity value) minus the fair value of assets acquired

Goodwill is not subject to amortization, but may be subject to impairment testing in accordance with FASB ASU No. 2012-02
Merger Accounting - Highlights

• Under ASC 805:
  • **Negative goodwill** will equal the excess of assets acquired at fair value minus the (liabilities assumed at fair value plus the entity value)

Negative goodwill is recognized as a “bargain purchase gain” through the income statement of the acquiring credit union

➤ When a “bargain purchase gain” is recognized, special rules apply when calculating regulatory net worth
Merger Accounting - Highlights

• Under ASC 805:
  • **Core deposit intangible** is subject to amortization over its useful life – usually 7 to 10 years

The core deposit intangible relates to the future earnings potential of the acquired membership and the value of receiving core deposits that are less expensive than the credit union’s marginal cost of funds.
Merger Accounting - Highlights

• Under ASC 805:
  • Loans acquired with deteriorated credit quality are recorded at fair value via a credit valuation account.
  • In most cases, the credit valuation account is 2.5 – 3.5 times the previously recorded allowance for loan losses (ALL) account balance.
  • Losses on the acquired loan portfolio are recorded to the credit valuation account – excess balance is accreted to interest income on loans.
Merger Accounting - Highlights

• Under ASC 805:
  • Premiums and/or discounts are recorded on acquired loan and investment portfolios to adjust contractual interest rates to fair value
  • Fair value adjustments are recorded to recognize off balance sheet assets or liabilities related to contractual lease obligations that are either above or below current fair value lease rental amounts
Merger Accounting - Highlights

• Under ASC 805:
  • Fair value adjustments (liabilities) are recorded to address costs that would not have been incurred if not for the merger transaction:
    - Termination costs related to the cancellation of vendor contracts
    - Branch closures with future lease obligations
    - Costs related to severance pay or termination clauses in employment agreements
Merger Accounting - Highlights

• Under ASC 805:
  • The acquirer has up to one year to make appropriate adjustments to fair value estimates that were based on incomplete information
  • The acquirer will NOT record the following accounts:
    - Allowance for loan losses
    - Equity accounts (U/E; R/R; AOCI)
Regulatory Issues

• The *entity value* is recorded on the balance sheet as a separate component of equity, however, is NOT considered a component of net worth.

• The retained earnings of the target credit union, *prior to the posting of fair value adjustments*, is considered a component of the acquiring credit union’s net worth and is reported in the PCA Net Worth Calculation Worksheet of the NCUA Call Report – lines 7(a) and 7(b).
Regulatory Issues

• If the merger transaction resulted in negative goodwill and the recognition of a “bargain purchase option,” that amount will be subtracted on line 7(c) in the PCA Net Worth Calculation Worksheet of the NCUA Call Report.

• The target credit union’s ALL account balance should be reviewed for reasonableness prior to the merger to ensure that the undivided earnings balance used for net worth purposes is not overstated.
Regulatory Issues

• Delinquent loans in the acquired loan portfolio *should be* recorded in the Call Report – same manner as credit union’s legacy loan portfolio

• Losses recognized on the acquired loan portfolio and any recoveries on the acquired loan portfolio *should not* be recorded as gross charge-offs and recoveries in the Call Report
Immaterial Mergers

- When the total assets and probable fair value adjustments of the target credit union are not material, it is common to record the merger transaction at book value – however, the following should be considered:
  - ALL account should be titled credit valuation discount
  - Retained earnings should be titled equity acquired in merger
  - Accumulated depreciation should be netted against cost of property and equipment
  - Get your external auditors involved to ensure the merger is considered immaterial
First Tech/Addison Avenue Merger Timelines and Trap lines

- Several processes needed to be done in parallel after the Q1 2010 merger announcement:
  - Member and employee communication
  - Merger application
  - Valuation
  - Member vote process and communication
  - System integration planning
Timelines and Trap lines

- Member and Employee Communication: With Addison being the surviving charter considerable resources were focused on communicating to the FTCU members and employees who ultimately had to vote.

- FTCU management conducted Town Halls in person and via WebEx for both members and employees.

- With members we discussed enhanced pricing, products and services, and the concept of size.

- With employees we emphasized the need for quality staff, opportunities that would be created via the merger and that staffing efficiencies would come via attrition.
Timelines and Trap lines

• Merger Application: To receive approval we needed to demonstrate why the merger made sense beyond just operational efficiencies
  • Thorough due diligence process
  • Safety and soundness via diversification
  • Member value via enhanced product offerings
  • Cost savings vs. cost avoidance
    - Identified over $65 million in operating expense savings over 5 years
      • Synergy Capture
Timelines and Trap lines

• Merger Valuation process
  • Outside expertise utilized:
    – ALM First: asset and liability valuation
    – RP Financial: entity value and CUSO valuations
    – Sacher Consulting: merger accounting resource
  • Valuation work was conducted three times
    – December 2009
    – September 2010
    – December 2010
Timelines and Trap lines

• Valuation demonstrated significant accounting advantages of FTCU being the acquirer
  • Significant Income statement impact differential
  • Greater marketability discount benefit
• Resulted in larger Goodwill of $74 million
  • Annual impairment testing
Timelines and Trap lines

• Member Vote Process and communication: Given uncertainty in merger approval timeline member vote process needed to be ready to be implemented quickly

• State statutes will vary in terms of timelines and other requirements for voting – must be keenly aware of legal aspects of vote – validity of vote cannot be questioned
  • Voting period
  • In-person vs. electronic
  • Process for member verification
Timelines and Trap lines

• System Integration: We began system integration prior to merger approval and member vote

• Formed executive merger steering committee Q1 of 2010
  • Establish guardrails for decision making – member value vs. cost
  • Identified key functions and personnel for integration
  • Selected outside consulting firm – West Monroe Partners
  • Selected head of Integration Management Office (IMO)
    – Interviewed internal and external candidates
Timelines and Trap lines

• System Integration: A merger of equals can make system integration more challenging
• Broader team meeting of key function leaders June 2010
  • Two in a box for key functions – lots of people at the table
  • Vertical focus can loose sight of horizontal implications
  • Personality vs. process can rule the day
Timelines and Trap lines

• System Integration: As part of the merger approval the regulators wanted to review our integration planning - the NCUA was on site for two weeks to review integration planning and interviewing key personnel

• We realized we needed a smaller, more cross functional focused integration effort and formed a core leadership team (CLT) in December of 2010

• Although we did not receive formal regulatory approval until October 2010 and member approval until December 2010 the integration date did not change - May 2011

• The IMO and CLT updated the management group on a weekly basis
Timelines and Trap lines

- System Integration: Although not without a few issues, system integration was very successful.
- Over 1.46 million accounts converted with 24 months of transaction history – 105 million transactions.
- 80 separate systems converted.
- In the course of 5 months – legal day one through conversion:
  - Introduced expanded product set
  - Launched rigorous branding campaign around the new name
  - Launched a new website with expanded capabilities.
Vendor Management Office

• With a merger comes tremendous opportunity for cost savings via vendor consolidation and negotiation

• Business unit owners often have too close of a relationship for effective negotiations

• The Vendor Management Office was formed in Q4 of 2010 for the specific purpose of capturing merger related savings

• We knew our system integration efforts would have a material cost (25 bps)– synergy capture helps put the cost in context
Vendor Management Office

- Regulatory application and messaging to the board identified over $65 million in cost savings over 5 years
  - Information Technology and related systems costs
  - Channel related costs
  - Other costs
  - FTE related costs
- Vendor Management Office tasked with achieving all cost savings excluding FTE related costs and building a disciplined vendor management process going forward
Vendor Management Office

- To date 80% of synergy capture goal has been identified with line of sight to 90%
- The VMO is an active participant with all business units during the annual planning process – accountability and discipline are critical to success
- Vendor level detail with executive level sponsorship to ensure accountability and specific responsibility
Lessons Learned

• All mergers are challenging – a merger of equals requires the right level of leadership and diplomacy

• Our cultures were so similar we did not focus on the differences

• Processes are just as important as systems if not more so

• Cross functional processes need to be mapped prior to conversion

• Strong project management skills at several levels are key

• Expect every member to try and log into home banking at the same time the second systems come up – load testing is critical
THANK YOU!

• Thank you for your attention and participation in today’s session!
Speaker Information

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