

# Bank Notes

November/December 2009

A timely information and idea statement

## Year End Accounting Update

There are a number of new accounting standards that will have accounting and reporting implications for banks in 2009 and/or shortly thereafter. The following highlights some of the more impactful recently issued standards.

Accounting Standards Codification (ASC) 855 (formerly FAS 165), *Subsequent Events*, established general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued (i.e., complete in a form and format that complies with generally accepted accounting principles (GAAP) and approved for issuance).

There are two types of subsequent events to be evaluated under this guidance: recognized subsequent events and nonrecognized subsequent events. An entity must recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Nonrecognized subsequent events involve subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but that arose after the balance sheet date but before financial statements are issued or are available to be issued. ASC 855 also requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date - that is, whether that date represents the date the financial statements were issued or were available to be issued. ASC 855 applies to both interim financial statements and annual financial statements and is effective for interim and annual periods ending after June 15, 2009, and should be applied prospectively.

Given the current economic environment, financial institutions should evaluate their policies, procedures and controls relating to the evaluation of subsequent events prior to the filing of call reports and the issuance of other financial statements to ensure recognized subsequent events are given proper accounting recognition.

ASC 320 was amended (formerly FSP 115-2 and 124-2) as it relates to the accounting and presenting of impairment losses on securities. The recognition guidance in this amended standard applies only to debt securities (not equity securities) classified as available for sale and held to maturity. Prior to the issuance of this guidance, when a financial institution determined

that a decline in the fair value of a debt security was other-than-temporary, the entire difference between the fair value and the cost basis of the security was charged to earnings. This is still the case when a financial institution intends to sell the security or when it is more-likely-than-not that the financial institution will be required to sell the security prior to recovery. When neither of these conditions is met, however, the new guidance allows a financial institution to bifurcate the unrealized loss. The portion of the unrealized loss that is due to credit deterioration is recorded in earnings, while the portion that is due to other factors is reflected in other comprehensive income.

Financial institutions that recorded other-than-temporary impairment charges prior to the effective date (which generally was June 30, 2009) of this guidance and are still holding those securities will need to determine the portion of the unrealized loss that is due to credit deterioration and the portion that is due to all other factors as of the adoption date. The portion of previously recorded other-than-temporary impairment charges that is not due to credit deterioration should have been reclassified to other comprehensive income as of the adoption date.

This amended guidance also requires expanded disclosures regarding investment securities. For example, instead of disclosing the amortized cost and fair value of mortgage backed securities, financial institutions will now be required to separately disclose residential mortgage backed securities and commercial mortgage backed securities.

The ASC is also being amended as it relates to accounting for transfers of financial assets (former FAS 166 and FAS 140). While this amended guidance will have a meaningful impact on companies that had qualifying special purpose entities, it also may have a significant impact to many community banks as it relates to accounting for their loan participation arrangements.

The revised guidance notes that a transfer of a portion of a financial asset will be eligible for sale accounting only if it meets the definition of a *participating interest*. A participating interest requires 1) proportionate ownership interest in an entire financial asset; 2) all cash flows (excluding fees for services) to be divided among participants in proportion to share of ownership; 3) rights of each participating interest holder have the

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## The Effect of FAS 141R on Bargain Purchases

FAS 141R (Accounting Standards Codification 805) changed the method of accounting for business combinations. FAS 141R is effective for business combinations with acquisition dates that occur in annual reporting periods beginning on or after Dec. 15, 2008.

FAS 141R requires the use of a “fair value” model rather than a “cost allocation” model in measuring assets acquired and liabilities assumed in a business combination. The “fair value” model is based on the principle that a business combination is a transaction in which an entity takes control of another entity, and that the fair value of the underlying exchange transaction should be used to establish a new accounting basis of the acquired entity. As such, FAS 141R results in the recognition of assets acquired and liabilities assumed at fair values, with limited exceptions.

FAS 141R has also had an impact on the accounting for bargain purchase transactions. A bargain purchase occurs if the acquisition date fair value amounts of the identifiable assets acquired and liabilities assumed, exceed the sum of 1) the value of consideration transferred; 2) the fair value of any non-controlling interest in the acquiree; and 3) the fair value of any previously held equity interest in the acquiree. The result of this mathematical exercise is also called “negative goodwill.” While FAS 141R indicates that a bargain purchase (negative goodwill) will be uncommon, a bargain purchase may occur when the entity being acquired is in a forced liquidation or distressed sale.

An acquisition of a failed bank from the regulators could meet the definition of a bargain purchase.

If a bargain purchase is initially identified, the acquirer should reassess whether all of the assets acquired and liabilities assumed have been identified and recognized, including any additional assets and liabilities not previously identified or recognized in the acquisition accounting. Once completed, the acquirer should review the procedures used to measure the following items:

1. Identifiable assets acquired and liabilities assumed
2. Non-controlling interest in the acquiree, if any
3. Acquirer’s previously held equity interest in the acquiree, if any
4. Consideration paid

The objective of reviewing each of these items is to ensure that the measurements used to determine the bargain purchase gain reflect all available information as of the acquisition date. If after this review, a bargain purchase is still indicated, the gain should be recorded in earnings of the acquirer. Under FAS 141R, the bargain purchase gain is no longer recognized as an extraordinary gain. The standard requires that the amount of the gain recognized, the line item where the gain is recognized and the description of the transaction that resulted in the gain be disclosed in the footnotes.

The application of FAS 141R is complicated, including the valuation of the loan portfolio, core deposit intangible and if applicable, any loss-share agreement with the FDIC. You should discuss specific transactions with your professional advisors.

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### Example of accounting for a bargain purchase

ABC Bank acquires XXX Bank assets and assumes deposits from the FDIC in a whole bank transaction for \$30 in cash consideration.

The fair value of the assets acquired and liabilities follow:

Cash	\$ 10
Loans	100
Investments	50
Building	5
Core Deposit Intangible	3
Less (deposits assumed)	(123)
Fair value of net assets	\$ 45

Provided that the fair value measures appropriately reflect the consideration of all the available information at the date of the acquisition, the \$15 (\$45-\$30) would be recognized in earnings as of the acquisition date.

## New Tax Planning Opportunities for Financial Institutions

The American Recovery and Reinvestment Act of 2009, signed into law on Feb. 17, 2009, provides several tax planning opportunities that financial institutions should consider before the end of the year. Additionally, the impact of the law changes and planning strategies should be considered when calculating the effective tax rate and deferred taxes for GAAP purposes.

Two of the new provisions provide for accelerated deductions on capital assets. The bonus depreciation provision allowing additional first-year depreciation of 50 percent of the cost of the asset was extended through 2009. Qualified property includes MACRS property with a recovery period of 20 years or less, certain computer software and qualified leasehold improvement property. The taxpayer must be the original user of the property.

In addition to the bonus depreciation provision, financial institutions making investments up to \$800,000 can write-off the entire cost of up to \$250,000 of capital expenditures incurred in 2009.

A small institution may desire to create a net operating loss in 2009 which can be carried back five years instead of the general two year period. The bonus depreciation and expensing of capital expenditures may assist with this planning strategy. For purposes of this provision, a small institution is defined as one with less than \$15 million average annual gross receipts for the three tax years ending with the NOL year.

Modifications were also made to the interest disallowance rules applied to institutions carrying tax exempt obligations. Currently, a bank generally may not deduct interest expense that is allocable to their investments in tax-exempt obligations. Certain obligations are considered "bank qualified" and only a

20 percent disallowance is applied. For other than bank qualified obligations a 100 percent disallowance rate is applies. The Act allows certain financial institutions to qualify for a de minimis rule which applies to other corporate taxpayers. This modification allows certain institutions to carry on average 2 percent of their assets in tax exempt obligations without imposing the interest disallowance. This modification only applied to obligations issued in 2009 and 2010. These obligations will be considered preference items for alternative minimum calculations.

The issue limit for "bank qualified" obligations was also increased from \$10 million to \$30 million for obligations issued in 2009 and 2010.

S corporations may also benefit from a provision in the Act which shortened the built-in gains holding period. S corporations that were previously C corporations often have built-in gains on assets that appreciated in value during the C corporation period. S corporations were required to hold those assets for ten years or be taxed, but the Act now temporarily reduces the holding period to seven years for 2009 and 2010. This provision is a planning strategy for institutions considering merger and acquisition activity or downsizing of balance sheets.

As with all tax planning strategies, state and local tax laws should also be considered. Certain states do not conform to federal regulations and different tax treatments may apply.

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same priority (i.e. there can be no recourse and no participating interest holder is subordinated to another); and 4) that no party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree. This amended guidance relating to participating interest will become effective Jan. 1, 2010 for calendar year companies and will apply prospectively to such transactions. Financial institutions should evaluate existing participation agreements and consider revising the terms of such arrangements to ensure that the agreements will qualify for sale accounting treatment under the new standard on a prospective basis.

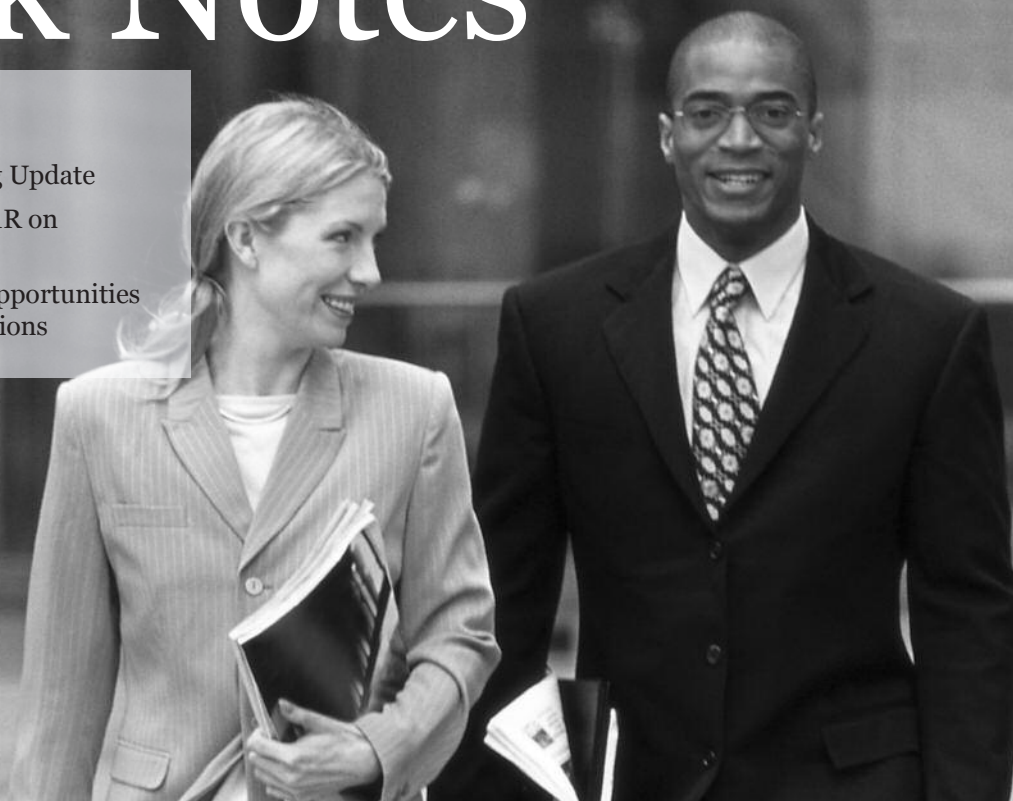
On June 24, 2009, the FASB issued an exposure draft entitled *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit*

*Losses*. The proposed statement would require enhanced disclosures about the allowance for loan losses and the credit quality of loans receivable. If adopted by the FASB, financial institutions would be required to provide enhanced disclosures. These enhanced disclosures would include much more disaggregated information about fair values of loans and rollforwards of both loans and the allowance for loan losses. Additional information would also be required related to loan delinquencies and the credit quality of the loan portfolio. As proposed, these new disclosures would be required in 2009 financial statements. The comment period has ended, and the FASB is currently reviewing the comment letters that were received. If this proposed statement is adopted, financial institutions will need to act quickly to add the required disclosures to the 2009 financial statements.

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## RSM McGladrey

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