# Strategic and Regulatory Considerations of Growing Your Financial Institution

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# Your Speakers


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# Agenda

- SOX/FDICIA Thresholds and Implications
  - Asset and capital growth
  - Additional reporting and testing requirements and the work required, primarily ICFR but there is more
  - FDICIA vs SOX thresholds, not the same or as close as they were
- Going Public
  - Considerations
  - SEC reporting
  - Listing standards of various markets
- Mergers and Acquisitions
  - Regulatory, accounting, and operational considerations
- CECL – we're banking CPAs, we have to talk about it

**Keep it interactive…please ask your questions**

# Why?

- Financial institutions are becoming larger intentionally
  - Gain economies
  - Organic growth/liquidity
  - Limited/no de novo activity
- Financial institutions are taking certain actions to impact growth
  - Mergers and acquisitions
  - IPOs/Demutualizations
  - Listing on exchanges or different exchanges

**This growth leads to increased expectations from all stakeholders…shareholders, regulators, customers, team**


# SOX Overview

# SOX Overview

- In 2002, the Sarbanes-Oxley Act (SOX) was signed into law, with the purpose of protecting investors through more reliable and accurate corporate disclosures and financial reporting in the wake of high-profile accounting cases earlier in the decade.

- Includes Section 404 (a) and 404 (b) requirements:
  - Section 404(a) - “Management’s Assessment” - requires management to report on the effectiveness of ICFR. Applies to all registrants regardless of size and filer status.

  - Section 404(b) - “Independent Auditor’s Assessment” – required for registrants that do not qualify as a SRC or EGC.

# SOX Overview (continued)

- In 2020, the SEC issued the final ruling amending the "accelerated and large accelerated filer definitions" reducing the number of financial institutions that were required to have an auditor attestation of their internal controls over financial reporting:
  - Annual revenue of less than $100 million in the most recent fiscal year that audited financial statements are available if public float is less than $700 million ("Smaller Reporting Company ("SRC") revenue test").
  - Threshold in the public float test to initially qualify as an SRC is less than $250 million.
  - Some issuers are now categorized as both SRCs and accelerated or large accelerated filers.
- Reminder to check your filer status annually.
  - Rising stock prices
  - Financial results

# SOX Overview (continued)

| Status | Public float | Annual revenues | Required to obtain auditor attestation over ICFR? |
|---|---|---|---|
| SRC and non-accelerated filer | Less than $75 million | No limit | No |
| | $75 million to less than $700 million | Less than $100 million | No |
| SRC and accelerated filer | $75 million to less than $250 million | $100 million or more | Yes |
| Accelerated filer (not an SRC) | $250 million to less than $700 million | $100 million or more | Yes |
| Large accelerated filer | $700 million and greater | Not applicable | Yes |

# SOX Overview (continued)

- Emerging Growth Company status, if eligible (no common equity solder under registration statement at December 8, 2011).
  - Continue to be an EGC for the first five fiscal years after an IPO is completed unless:
    - Total annual gross revenues are $1.07 billion or more
    - Issued more than $1 billion in non-convertible debt in the past three years, or
    - Become a "large accelerated filer" as defined in Exchange Act Rule 12b-2

- EGCs are permitted the following:
  - Include less extensive narrative disclosure than required of other issuers, particularly in description of executive compensation
  - Provide audited financial statements for two fiscal years versus three years
  - Do not require an auditor attestation of internal control over financial reporting under Section 404(b)
    - If over $1 billion in assets, then FDICIA may still require an audit of internal controls over financial reporting
  - Ability to elect to defer complying with certain changes in accounting standards

# FDICIA Overview

# FDICIA History

## Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)

FDIC passed FDICIA to strengthen the banking environment and to reduce the negative impacts of the savings and loan crisis of the 1980s and early 1990s.

FDICIA included key provisions affecting the banking industry:

- Prompt corrective action (PCA) provision
- Least-cost resolution provisions
- Improved examinations
- Adjusted the conditions for an institution to qualify for an 18-month, full scope, on-site examination, increasing the volume of institutions subject to these examinations
- Truth in Savings Act (TISA)

# FDICIA Overview

## Section 112 Requirements

Requires management of insured depository institutions meeting certain asset size tests to issue a report on:

- The effectiveness of the institution's internal control over financial reporting
- The entity's compliance with designated laws and regulations

*Management is required to make assertions regarding the effectiveness of internal control over financial reporting and compliance with designated laws and regulations. In addition, management is required in certain cases to engage an auditor to perform an audit of the effectiveness of internal control over financial reporting.*

# FDICIA Overview

## Section 36 and Part 363

In 1993, FDIC adopted final rule to facilitate:

- Early identification of problems in financial management through annual independent audits
- More stringent reporting requirements
- Internal controls over financial reporting

Part 363 applies to insured depository institutions with **$500 million or more in total assets ("covered institution")** at the beginning of its fiscal year:

- Requires specific reporting
- Requires each covered institution to establish an independent audit committee
- Includes guidelines and interpretations to assist covered institutions and auditors in compliance

Notes:

1. Part 363 amended in 2005 to raise asset size to $1 billion for internal control assessment requirements by management and external auditors
2. COVID relief granted in 2020 for internal control assessment requirements by management and external auditors

# FDICIA Overview

## Annual Reporting Requirements ($1 billion or more in total assets)

- Audited comparative annual financial statements, including independent auditor's report
- Management's report **(signed by CEO and CFO)**
  - Statement of management's responsibilities for:
    - Preparing the annual financial statements
    - **Establishing and maintaining an adequate internal control structure and procedures for financial reporting**
    - **Complying with certain laws and regulations relating to safety and soundness**
  - Assessment by management on the effectiveness of the institution's internal control structure over financial reporting as of the end of the fiscal year that must:
  - Identify the internal control framework used by management to evaluate the effectiveness of internal control over financial reporting (e.g., COSO 2013)
  - State that the assessment included controls over the preparation of regulatory financial statements in accordance with regulatory reporting instructions and identify the regulatory reporting instructions
  - **Disclose all material weaknesses in internal control over financial reporting, if any, that management has identified that have not been remediated prior to the institution's fiscal year-end (management is precluded from concluding that the institution's internal control over financial reporting is effective if there are one or more material weaknesses)**
  - An assessment by management of the insured depository institution's compliance with such laws and regulations during such fiscal year

# FDICIA Overview

## Annual Reporting Requirements ($1 billion or more in total assets)

- **The independent public accountant's audit report concerning the effectiveness of the institution's internal control over financial reporting.** The accountant's report must:
  - Identify the internal control framework used by the independent public accountant, which must be the same as the internal control framework used by management, to evaluate the effectiveness of the institution's internal control over financial reporting
  - State that the independent public accountant's evaluation included controls over the preparation of regulatory financial statements in accordance with regulatory reporting instructions and identify the regulatory reporting instructions
  - State the independent public accountant's conclusion regarding whether internal control over financial reporting is effective as of the institution's fiscal year-end
  - Disclose all material weaknesses in internal control over financial reporting, if any, that the independent public accountant has identified that have not been remediated prior to the institution's fiscal year-end (the auditor is precluded from concluding that the insured depository institution's internal control over financial reporting is effective if there are one or more material weaknesses)

# FDICIA Overview

## Other FDICIA Provisions

- **Auditor independence under AICPA, SEC and PCAOB rules (partner rotation)**
- Independent audit committee
- Audit committee duties:
  - Reviewing with management and the independent public accountant the scope of services required by the audit, significant accounting policies, and audit conclusions regarding significant accounting estimates
  - Reviewing with management and the independent public accountant their assessments of the adequacy of internal controls, and the resolution of identified material weaknesses and reportable conditions in internal control, including the prevention, or detection of management override or compromise of internal control
  - Reviewing with management and the independent public accountant the institution's compliance with laws and regulations
  - Discussing with management the selection and termination of the independent public accountant and any significant disagreements between the independent public accountant and management
  - Determining the appointment and compensation and providing oversight of the independent public accountant, including ensuring that audit engagement letters do not contain unsafe and unsound limitation of liability provisions
  - Overseeing the internal audit function

# Internal Control Documentation

## FDICIA Internal Control Documentation

- Process narratives
- Matrices detailing key controls
- Walk-throughs of certain key controls
- Documentation of control activities (e.g. reconciliations, approvals, user access support)

- Provides evidence of control structure – design effectiveness
- Details key controls and drives testing – operating effectiveness
- Support for CEO/CFO attestations
    - Basis for "sub-certification process" – key process owners attesting to the CEO and CFO about the accuracy and ongoing compliance with agreed upon controls
- Audit trail for external auditors

# Internal Control Process Examples

## FDICIA Internal Control Processes

- Corporate Governance (Entity Level)
- Finance
- General Ledger Posting and Closing (including Financial Reporting and Call Report)
- Human Resources and Payroll
- Cash Disbursements and Accounts Payable
- Deposit/Branch Operations
- Wire Transfers
- Residential Lending Operations
- Commercial Lending Operations
- Other Real Estate Owned
- Allowance for Loan Losses
- Taxation
- Information Technology
- Mergers and Acquisitions

# FDICIA and the Audit Committee

## Audit Committee Duties (FDICIA)

- Reviewing with management and the independent public accountant the scope of services required by the audit, significant accounting policies, and audit conclusions regarding significant accounting estimates
- Reviewing with management and the independent public accountant their assessments of the adequacy of internal controls, and the resolution of identified material weaknesses and reportable conditions in internal control, including the prevention, or detection of management override or compromise of internal control
- Reviewing with management and the independent public accountant the institution's compliance with laws and regulations
- Discussing with management the selection and termination of the independent public accountant and any significant disagreements between the independent public accountant and management
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# Internal Control over Financial and Regulatory Reporting

# Importance of ICFR Process

- Management's testing specifically supports Management's assertions and provides evidence of a sound internal control structure for both Management's reporting requirements as well as a building block for the independent auditor's attestation requirements
- Consequences of internal control deficiencies and potential for issuance of any report other than an unqualified opinion on internal control from Management or the Institution's external auditors:
  - Potential increase in regulatory scrutiny
  - Decreased investor confidence
  - Decrease in marketability of the Institution's stock
  - Potential penalties for the Institution and/or the Institution's Management

# Documentation

- Documentation evidencing both the design effectiveness and operating effectiveness of controls is paramount in implementing an adequate ICFR program.
- This should include documentation that demonstrates who performs a control, if they rely on any supporting processes in performing their control, how often they perform the control and information sufficient to clearly show what performance of the internal control entails.
- The level of documentation necessary is not the same for every control. Each control should have unique documentation with the amount commensurate with the complexity and subjectivity of the internal control.

**Often, we see control breakdowns during the extended absence of an employee or when turnover occurs in a department. It is important for Management to identify these situations to ensure consistent performance and documentation of controls.**

# Testing of Controls

- Testing of internal control over financial reporting is a Management function. Typically, Institutions the size of community financial Institutions delegate the testing of design and operating effectiveness to the internal audit group or another third-party for efficiency, independence and credibility purposes.
- Management should coordinate discussion between the group designated to test controls for Management's assessment and the external auditor. Whether an independent auditor's assessment of ICFR is required or not, audit efficiencies can generally be gained if the control testing performed for management's is performed in a manner sufficient to be utilized by the external auditor.
- Key components that should be discussed between Management and external audit include sample sizes, identification of Management review controls ("MRCs"), logistics for how testing and supporting documentation will be shared, the extent to which internal audit will retain supporting documentation, which areas external audit plans to place reliance on Management's testing and timing of testing.
- Testing performed by/for Management should include verification of both the design and operating effectiveness of all key internal controls and processes.

# Testing of Controls

- While the listing of key ICFR controls as designated by Management can differ from those designated by external audit, consensus in the industry is that maximum efficiency is achieved and the potential for significant audit concerns is reduced by keeping these lists consistent.

# Helpful Tips

- Third-party solutions are available for organizing documentation, including testing, if performed in-house
- If not utilizing a third-party solution, we have seen clients successfully use a combination of Word documents for process narratives, Excel documents for key control grids and network folders for organizing testing
- Creating a master listing of all controls is beneficial
  - Allows you to identify potential control duplication
  - Helps identify situations where you may have too many controls

# Internal Control Reminders

- Control activities to remember:
  - Segregation of duties
    - No one person can control elements of a key process
    - Reduces the likelihood of collusion
    - Lower probability that two persons will make the same error
  - Information Technology general controls
    - Controls to maintain the completeness and accuracy of the underlying data and information
    - Controls to support the reliability of automated controls and system-generated reports
    - Include controls in information security, application development, and systems maintenance and operations
    - Map user considerations in SOC reports to actual control
  - Entity-level and process-level controls
    - Entity level controls have a pervasive effect on system of internal controls
    - Example of entity-level control - audit committee oversight of financial reporting

# Internal Control Reminders(continued)

- Control activities to remember (continued):
    - Process-level control – pertains to a single activity such as ensuring new loans are approved in accordance with authorized limits
  - Preventive and detective controls
    - Preventive controls are intended to prevent the occurrence of an activity that is not consistent with the control objective
      - Can be automated or manual
      - Automated example - Limiting Access to IT systems
      - Manual example - Separating Approval and Payment
    - Detective controls are intended to identify misstatements or unauthorized activities after they have occurred so that corrections can be made in a timely manner
      - Example – reconciliations that compare two sets of records (e.g. due from bank reconciliation)
      - Example - Management review controls (MRCs) – typically involve comparing recorded financial statement amounts to expected significant differences from expectations (e.g. monthly comparison of actual results to budgeted)

# Internal Control Reminders (continued)

- Smaller company considerations:
  - Risk of management override of controls may be greater given management generally has more direct involvement with operations and recording of transactions
  - May not have sufficient personnel to fully implement segregation of duties across all processes
  - Regardless, still required to implement a control system that will provide reasonable and supportable assurance that internal control over financial reporting is effective
- ICFR Deficiencies
  - When deficiencies in the design or operation of a control are found, management needs to assess how serious the impact may be on the integrity of the financial reporting process
    - Likelihood of a misstatement occurring as a result of the deficiency
    - Magnitude of potential misstatement that is reasonably possible to occur
    - Whether management's controls in the ordinary course of business would have timely prevented or detected a misstatement had it become material

# Benefits of SOX/FDICIA Controls

- Potential leverage by internal audit to reduce risk and testing frequency
- Thoroughly documenting processes and key controls could result in a nice training tool
- Allows CEO and CFO to sleep well knowing controls are in place and operating effectively
  - Quarterly and/or annual certifications
  - Potential for significant penalties

# Going Public and Market Listing Considerations

# Going Public

- Needed access to capital markets
- Liquidity/transferability for current shareholders
- Specific transaction(s)

# Going Public Considerations

- Consider:
  - Current internal expertise (CEO, CFO, Accounting)
  - Current internal control environment
  - Current board make-up
  - Current advisors and other external resources
  - Auditor expertise and/or PCAOB status, also ability to rotate partners
  - Potential move from non-PBE to PBE
  - Risk tolerance
  - Requirements specific to certain markets
  - Time
  - Expense

# Going Public Considerations

- Stringent deadlines
  - Will need to be concentrated around (before) 10-Q/10-K deadlines
    - 10-Q due date:  45 days after quarter end
    - 10-K due date:  90 days after year end

      **Both subject to change when departing SRC/EGC filer status
- Review and approval of filings by management, auditor, and legal counsel
  - Earnings releases, 10-Q, 10-K, other significant filings
    - Must recommend annual financial statements be included in Form 10-K
- Board and Audit Committee membership
- Quarterly evaluations of internal controls
- Evaluation of activities in comparison with listing standard requirements
  - Independence of committee members
  - SEC Expectations

# Certain Listing Requirements

| Required by | Duties | How Often |
|---|---|---|
| SEC<br>NASDAQ | Review and approve related party transactions. | As needed or Quarterly |
| SEC<br>NASDAQ | Compensate, retain, and oversee the work of the independent auditor for the purpose of preparing or issuing an audit report. | Ongoing |
| SEC | Oversee the resolution of disagreements between management and the independent auditor as they arise. | As needed |
| SEC | Discuss with the independent auditor all matters required to be discussed under the standards of the PCAOB. | As needed (at least annually) |
| SEC<br>NASDAQ | Assess the financial literacy and qualifications of all audit committee members, as well as identifying any financial experts. Determine whether members are in compliance with applicable rules and regulations. | Annually |
| SEC<br>NASDAQ | Review adequacy of whistleblower procedures for receipt, retention, and treatment of complaints. Should ensure a method of confidential/anonymous submission is included. | Annually |
| SEC | Review the code of ethics as well as the registrant's monitoring systems for compliance and enforcement of the code. | Annually |

# Certain Listing Requirements

| Required by | Duties | How Often |
| --- | --- | --- |
| SEC<br>NASDAQ | Monitoring compliance with independence rules and regulations. | Ongoing |
| NASDAQ | Dialogue with independent auditor concerning any disclosed relationships/services that may impact independence and objectivity of the auditor. | Annually<br>As needed |
| SEC | Prepare/sign-off on the audit committee report to be included in the annual proxy statement. | Annually |
| SEC | Review management certifications on internal control. | Quarterly |
| SEC | Recommend to the Board that the financial statements should be included in the Company's report on Form 10-K. | Annually |
| SEC<br>NASDAQ | Appoint the independent auditor. | Annually |
| SEC | Pre-approve audit and non-audit services performed by the independent auditor. | As necessary |
| NASDAQ | Review audit committee charter and recommend to the Board any necessary changes. | Annually |

# Certain Listing Requirements

| Required by | Duties | How Often |
|---|---|---|
| SEC<br>NASDAQ | As necessary, engage outside consultants (legal, accounting, or other) to the audit committee and provide funding to compensate those advisors. | As needed |
| SEC | In conjunction with management, make proper disclosure as to whether at least one member of the audit committee has been determined to be a "financial expert", as defined by the SEC. | Annually |
| SEC | Review and discuss with management and the independent auditor the Company's 10-Q's and 10-K's prior to filing. | Quarterly |
| SEC | Prior to filing periodic financial statements, receive the report form the independent auditor required by Rule 2-07(a)(3) of Reg. S-X, including critical accounting policies and practices, alternative accounting treatments, other material written communications between the independent auditor and management. | At least annually |

# Listing Best Practices

| Required by | Duties | How Often |
|---|---|---|
| Best Practice | Conclude each regular meeting with an executive session, including private meetings with the independent auditor. | Quarterly |
| Best Practice | Review with management the accounting department, its budget, the sufficiency of resources, and quality of personnel. | Annually |
| Best Practice | Discuss earnings releases in detail. | Quarterly |
| Best Practice | Discuss any earnings guidance or financial information provided to analysts and ratings agencies. | At least annually |
| Best Practice | Review all reports from the internal audit function, including those concerning internal control. | Quarterly |
| Best Practice | Discuss the quality control processes employed by the independent auditor. | At least annually |
| Best Practice | Review with the internal and independent auditors the adequacy of the Company's disclosure controls and procedures as well as internal control over financial reporting. | Quarterly |

# Listing Best Practices

| Required by | Duties | How Often |
| --- | --- | --- |
| Best Practice | Discuss with the disclosure committee and/or its chair to discuss any items of significance. | Quarterly |
| Best Practice | Meet with management concerning the adoption/application of any significant accounting principles. | As needed |
| Best Practice | Meet with management to review prior control deficiencies and their status. | Quarterly |
| Best Practice | Review all complaints on questionable accounting, auditing, or internal control matters. | As needed |
| Best Practice | Provide complete oversight of the internal audit function and discuss status of the internal audit program with the independent auditor. | Annually |
| Best Practice | Participate in appropriate continuing education. | Ongoing |

# Going Public Takeaways

- Have a good reason to undertake
- Make sure you have strong advisors (legal, audit, internal audit) with significant expertise and experience with the SEC and banking…you might need to change
- Be considerate about your internal resources and Board make-up…you might need to hire
- Carefully assess the specific requirements of the SEC and the market you are considering listing on
- Know the risks
- Don't hesitate to add necessary resources
- Spend the time and money to stay current


# Mergers & Acquisitions

# Goals for M&A Discussion

- Focus on accounting
- Understand acquisition accounting and recognition concepts (before entering a deal and it's too late)
  - Day One concepts and potential complexities
  - Day Two concepts and potential pitfalls
- Briefly introduce other merger considerations

# Day 1 Accounting Overview

**Who is the Acquirer?**

- The Acquirer is the combining entity that gains control over the business
- Typically, readily apparent after considering which party is transferring cash and issuing stock
- Other considerations:
  - Larger in terms of relative size (assets, revenues, earnings)
  - Possesses the largest portion of the combined entity's voting rights
  - Controls majority of the combined board
  - Provides a dominant portion of the combined entity's management
  - Pays a premium to acquire the equity interests of the target

# Day 1 Accounting Overview (continued)

**What's the Acquisition Date?**

- The date the acquirer obtains control of the target, which is generally the closing date
  - Acquisition date may only be different from the closing date if there is a written agreement transferring control on a different date
- On acquisition date, all amounts on the target's balance sheet are measured at fair value
- Measurement of the acquirer's stock issued in the transaction is based on fair value at acquisition date
  - Not announcement date
  - Don't get confused with the exchange value used in the merger document

# Day 1 Accounting Overview (continued)

## Is this thing taxable or tax-free?

- Generally determined by lead counsel’s tax expert with a formal tax opinion issued and included in filing
  - Should ensure that external auditor agrees with expert’s determination

# Day 1 Accounting Overview (continued)

## Basics of taxable versus tax-free acquisition

- **Taxable transactions**
  - Taxable to the Target because the assets and liabilities are sold and assigned to the Acquirer
  - Target's shareholders pay the tax on the transaction
  - Acquirer's tax bases in assets and liabilities are stepped up, generally to fair value
  - Acquirer's tax bases in acquired assets and liabilities equals consideration transferred
  - Taxable transactions have few temporary differences/deferred taxes recorded at closing

# Day 1 Accounting Overview (continued)

## Basics of taxable versus tax-free acquisition (continued)

- **Non-Taxable transactions**
  - Ownership interests are sold to the buyer and often referred to as stock sales
  - Original tax bases of the Target is retained and transferred to the acquirer
  - Nontaxable transactions result in numerous temporary differences for deferred taxes, because the tax bases of the Target's assets and liabilities are the same as before the acquisition (i.e., carryover basis is used for tax purposes) versus book bases based on acquisition date fair value
  - NOLs and other credits of the Target carryforward to the acquirer, but may be reduced or limited depending on the specifics of the transaction (IRC Section 382)

# Day 1 Accounting Overview (continued)

## Need an Acquisition Accounting Refresher?

- All assets and liabilities of target recorded at **fair value** at **acquisition date**
  - Difference between purchase price (determined at acquisition) and net fair value of assets and liabilities = goodwill or bargain purchase gain
  - If bargain purchase gain, standards require extra precaution to check, and double check, the validity of the fair values and disclose why the target was willing to sell at that price
  - Will need to engage a qualified valuation expert early in the process
    - Cannot use projections performed by investment bankers in the initial due diligence
    - Expect your auditor to also use a valuation expert
  - Most difficult asset to value is the loan portfolio
    - FV considers credit (risk of default), interest (risk due to variability of rates), and liquidity (market dynamic) risks

# Day 1 Accounting Overview (continued)

**Need an Acquisition Accounting Refresher?**

- Review SERP, deferred compensation and employment agreements early in the process
- Don't forget sub debt, FHLB advances and other investments
- Consideration transferred generally includes the following:
  - Cash
  - Equity interests issued
    - Common Stock
    - Preferred Stock
    - Replacement Awards – options, restricted stock, warrants
  - Contingent Future Payments

# Day 1 Accounting Overview (continued)

## Whose expense is this anyway?

- **Acquisition-Related Costs**
  - Incurred for the transaction (i.e., finder's fees, advisory, legal, accounting, valuation, cost to register, and issue debt securities)
    - All **expensed as incurred**, with one exception
      - Costs to issue debt or equity securities recognized in accordance with other applicable GAAP
- **Severance/Stay Bonuses**
  - Considered to be for the benefit of the acquirer
  - Severance offered to employees who will be displaced after closing is recorded as an expense of the combined entity in the post-combination financial statements of the acquirer
  - Employees paid a bonus to remain with the entity to ensure a smooth transition/conversion will also result in a post-combination expense of the acquirer

# Day 1 Accounting Overview (continued)

## Whose expense is this anyway?

- **Change in Control payments**
  - Need to analyze to determine whether they represent compensation for 1) pre-combination services, 2) post-combination services, or 3) a combination of both
  - Factors to consider:
    - Reason for the transaction
    - Who initiated the transaction
    - Timing of the transaction
  - Could also have an impact on deferred compensation plans, SERPs
  - Pre-combination services (TENDS TO BE RARE)
    - Target entered into employment agreements with executives prior to contemplation of the merger in order to attract and retain talent. Agreements stipulate that in the event of a CIC the executives receive a payment, golden parachute, that does not require post-combination service
    - Expense of the target
    - Accounted for as consideration transferred
    - Ultimately reduce the target's equity used in calculating goodwill

# Day 1 Accounting Overview (continued)

## Whose expense is this anyway?

- **Change in Control payments (continued)**
  - Double Trigger (MORE TYPICAL)
    - Employment agreement contains a clause that effectively puts the decision of the executives continued employment on the Acquirer
    - Given the Acquirer makes the decision, the accounting is different than other pre-existing employment contracts
  - Example: Contract entered into with executive in 2018 states that executive receives $250,000 in the event the Bank is acquired by another company and the executive's employment is terminated or responsibilities reduced significantly after the acquisition. Acquirer offers the CEO of the target a position as COO. Executive is entitled to receive $250,000.
      - Employment agreement in existence prior to negotiations
      - Events required for executive to receive payment
        - Change in Control
        - Executive's duties significantly reduced by Acquirer
        - Decision of acquirer to change duties - **Expense of the Acquirer**

# Day 1 Accounting Overview (continued)

**Whose expense is this anyway?**

- Core data processing contract termination
- Remember the three questions?
  - Reason? – Acquirer does not want the cost of two vendors and wants to be on the same system for efficiency purposes
  - Who initiated? – Only initiated due to being acquired
  - Timing? – Usually in conjunction with or shortly after acquisition closes
- Expense belongs in the post-combination financials of the combined entity <u>regardless of who pays the termination fee and when</u>

# Day 2 Accounting Overview for Loans

***Remember all acquired loans are initially recorded at acquisition date fair value on the Acquirer's financial statements…no related allowance for loan losses comes over from the Target (pre-CECL adoption)***

# Day 2 Accounting Overview for Loans

**Good Book or Bad Book loan?**

- **Good Book** – acquired performing loans
  - Day 2 accounting is fairly simple
  - Follows ASC 310-20, formerly FAS 91
  - Credit, interest, and liquidity marks are accreted over contractual life using the effective yield method

- **Bad Book** – purchased credit impaired/purchased credit deteriorated
  - Day 1 and Day 2 accounting is more complex
  - Accounting follows ASC 310-30
  - Must have evidence of credit deterioration
    - Delinquent, nonaccrual, adversely classified, impaired, TDR
  - Must have expectation that creditor will not collect all contractual cash flows
  - FV marks are accreted over the EXPECTED life using effective yield method
  - Regular re-evaluation of expected cash flows required

# Day 2 Accounting for Loans - CECL

## CECL Implications

- Terminology changes to purchased credit deteriorated (PCD) and non-PCD loans
- Under CECL, acquired assets that have only insignificant credit deterioration (the old good book loans/performing loans) will be treated similarly to originated assets
  - Requires bank to record a CECL allowance for all remaining good book loans from prior acquisitions even if the remaining marks would result in no allowance using the current allowance methodology
- Executives considering transactions that will close near the CECL adoption date should model non-PCD loans along with the legacy portfolio
  - Impact on regulatory capital and tangible BV

# Day 2 Accounting for Loans (continued)

## PCI/PCD Loan Considerations

- Accretable yield versus nonaccretable difference
- Renewals of bad book loans
  - Retain their designation as bad book
  - Unaccreted marks attach to the renewed loan and continue to be recognized as a yield adjustment over the life of the loan
- Payoffs during measurement period
  - Review to determine if information existed at acquisition date that wasn't readily available that if known would have resulted in a different credit mark
  - Goodwill adjustment versus accretion income
- Provision for loan losses/allowance for loan losses recorded when the expected cash flow expectations indicate the remaining unaccreted marks (all, not just credit) are not sufficient to cover the expected shortfall

# Common Acquisition Pitfalls

**Loan Accounting**

- Failure to eliminate Target's unamortized loans costs/fees as part of Day 1 accounting
  - Sometimes requires assistance from vendor to ensure elimination in any conversion
- Charge-offs during measurement period
  - Review to determine whether condition existed at the date of acquisition that if known by the acquirer would have resulted in the creation of a different credit mark
  - Goodwill measurement period adjustment
- Renewals of PCI loans receive a new loan number resulting in the unaccreted marks being incorrectly recorded to interest income
  - Need a quarterly process to review loans removed from PCI category to determine if renewed or paid-off (Day 2 vendor will not know if the loan number changes)

# Common Acquisition Pitfalls (continued)

**Loan Accounting (continued)**

- Over-reliance on valuation expert
    - Need a process to ensure the credit and liquidity marks assigned are reasonable given the remaining maturity of the loan
    - Excess accretion income recorded during a quarter, especially immediately following closing, may be an indication that the initial fair value mark was inaccurate – too high
    - Provision expense required to be recognized on the performing loan portfolio by the combined entity immediately following closing is an indication that the initial fair value mark was inaccurate – too low
    - Responsibility of the acquirer to perform a documented review of the valuation report including the assumptions made for any potential inaccuracies

# Common Acquisition Pitfalls (continued)

**Fixed Assets/OREO/Leases**

- Failure to order appraisals for real property (land and buildings) – fixed assets and OREO
- Failure to fair value leases (cannot just carry over lease asset and lease liability recorded by target without additional analysis) – asset or liability determined on favorable/unfavorable lease terms at time of acquisition
- Original cost basis of fixed assets will need to be retained for tax purposes for all tax-free exchanges
    - Depending on the fixed asset system used by the acquirer, this can cause issues and should be addressed in pre-closing planning
- Previously recorded accumulated depreciation of the target will not carry over to the acquirer for GAAP purposes
    - Depreciation expense will be recorded by the combined entity based on the estimated useful life at date of acquisition

# Common Acquisition Pitfalls (continued)

## Other Areas

- Improperly carry over goodwill and CDI previously recorded by target
- Costs to issue debt recorded as expense
- Securities
  - Original cost of securities needs to be retained for tax purposes in a tax-free exchange
    - Most securities accounting agents can accommodate, but need to plan early in the process
- Prepaid expenses and other asset/liability accounts of Target not analyzed to ensure they have value/ongoing obligation to the combined entity
- Deferred taxes recorded incorrectly – especially in taxable transactions
- Including acquisition expenses as fully tax deductible in tax calculation
  - Understand the tax law early in the process so that expenses can be appropriately segregated on general ledger as non-deductible, 70% deductible, 100% deductible

# Common Acquisition Pitfalls (continued)

## Other Areas (continued)

- Failure to properly document/review assumptions and amounts used by valuation expert
- Failure to properly document/review initial goodwill calculation
- Failure to include replacement equity awards in consideration transferred
- Using wrong stock price to calculate consideration transferred
- Pushing expense to target that belongs in post-combination income statement of combined entity

# Measurement Period

- *Reasonable time period after the acquisition date when the Acquirer may adjust the "provisional" amounts recognized for a business combination if the necessary information is not available by the end of the reporting period in which the acquisition occurs*

- Some common measurement period adjustments
  - Loan charge-offs
  - Loan pay-offs
  - OREO sales
  - New appraisals
  - Updated actuarial reports on benefit plans

# Other Merger Considerations

- Don’t forget controls (pre and post merger)
- Culture – be intentional
- Communication – over-communicate
- Use champions/teams
- Post-acquisition benefit plans
- Employee on-boarding and education regarding pay/benefits
- Look for resources to help

# CECL

# CECL Overview

- For all entities that have not yet adopted, CECL becomes effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.
- While the focus has been on loans held for investment, the scope of CECL also applies to:
  - Most debt instruments (e.g., held-to-maturity investment securities), other than those measured at fair value through net income
  - Trade receivables and contract assets recognized under ASC 606
  - Certain lease receivables (e.g., lessors in sales-type and direct financing leases)
  - Reinsurance receivables from insurance transactions
  - Financial guarantee contracts (e.g., standby letter of credit)
  - Loan commitments

# CECL Overview

**Where should my institution be today?**

- Expectation that institutions have determined the approach to be utilized for CECL and are running parallel models, evaluating results, and projecting the initial retained earnings adjustment.
- Model validation should occur BEFORE the model is put into use and is a required step for both outsourced and internally developed models.
    - Validation should be performed by an individual or team separate from model development and use, such as internal audit or experienced, outsourced third-party.
- Include external auditors in discussion of status of CECL implementation, documentation of parallel runs, results of model validation, and changes to control environment.
- Institutions should be reviewing disclosure requirements to ensure they are prepared for the enhanced financial statement disclosures under CECL (more to come).
- Document potential impact to other areas, such as Asset Liability Management & Capital Planning/ Stress Testing.
- Consider impact to internal controls:
    - ***All*** institutions should be revising documentation of policies and processes related to CECL's impact on internal controls (especially important for SOX/FDICIA).
    - Establish plan for integration of CECL into internal audit risk assessments and audit plans.

# CECL Overview

**Corporate Governance**

- Even when outsourced, the management of activities conducted through third parties (e.g. outsourced CECL vendors) is the responsibility of senior management and the Board of Directors.
- Key elements of oversight related to CECL
  - Review audit reports or other reports (SOC1) of the third party.
    - Evidence management's thorough review
    - Acknowledge and review management responses for any deficiencies in the report
    - Document Complimentary User Entity Controls ("CUECs")
  - Manage model risk by challenging the model and through independent validation.

# CECL Overview

**Key Takeaways:**

- Don’t forget about the other implications of CECL.  The impact on loans is the most significant area, however securities and off-balance sheet items are also impactful.
- It’s not too late.  Assess where you are and map out a plan that includes checkpoints that align with adoption dates.  Do you have a CECL Committee?
- Involve your Board of Directors.

# Model Validation & Internal Control Considerations

**CECL Model Validation** - Overview

- CECL model validation applies to vendor models as well as those developed internally.
- Impact of model and the resulting need for validation:
  - Results have a direct and material impact on the financial statements
  - Reputational risk exists due to potential restatement due to model error
  - CECL models may influence loan origination decisions, including terms, pricing and product offerings
  - Models are relatively new and complex which will draw scrutiny from auditors and regulators
  - Questions raised during model validation could help management refine decisions made in developing the model

# Model Validation & Internal Control Considerations

**CECL Model Validation** - Depth of validation & key components

- Getting started: Pick the right individual or team for the validation.
  - Should be performed by individual(s) with appropriate incentives, competence and influence
  - Consider those independent from model development and use
  - Consider internal audit or outsourced provider
- Validation should occur before the model is put into use.
- The validation should identify model weaknesses and limitations, in addition to confirming the model is operating as designed.

# Model Validation & Internal Control Considerations

**CECL Model Validation** - Depth of validation & key components

- Rigor and sophistication of validation should be commensurate with the complexity of the model.
- Validation activities should continue on an ongoing basis after a model goes into use and include back-testing.
- Results of validation should be shared with appropriate Board committee.

Additional information on model validation can be found in the FDIC's "Supervisory Guidance on Model Risk Management"

- **Supervisory Guidance References:** FDIC FIL 22-2017, OCC 2011-12 & SR Letter 11-7

# Model Validation & Internal Control Considerations

**Internal control considerations** - Overview

- Regardless of asset size, internal controls related to CECL implementation need to be considered.
- Level of documentation should be commensurate with asset size and standing (i.e., different levels expected for smaller banks than those subject to FDICIA over $1 billion and SEC).
- In most cases documentation should provide an audit trail for the data used (including completeness of reports), management assumptions made, and qualitative adjustments.
- The level of documentation necessary is not the same for every control. Each control should have unique documentation with the amount commensurate with the complexity and subjectivity of the internal control.
- Stay organized and do not place undue reliance on vendor.

# Model Validation & Internal Control Considerations

**Internal control considerations** – Common CECL controls

- Some of the more common controls to consider at your institution include:
  - Best practice to prepare a memo that summarizes the implementation process.
    - Inclusive of management's decisions for methodology and segments appropriateness, appropriateness for reasonably supportable forecast period, peer group, period to determine loss rates, steps taken to verify data going into the model, qualitative factors utilized, etc.
      - Many of the vendors include a "road map" that summarizes a lot of this information
      - This would be a one-time 2022 exercise
    - This standard is new for everyone (including your regulators) so you will be getting questions about decisions made and implementation of the model. Best practice to have a document that summarizes decisions made.

# Model Validation & Internal Control Considerations

**Internal control considerations** – Common CECL controls (continued)

- Policy – make sure you are updating your policy to reflect changes in your methodology and controls.
  - This will include any changes to loan modification/TDR procedures as a result of ASU 2022-02 (covered later)
  - Should also include changes from "impaired loan" concept to "collateral dependent" methodology
- Review checklist/summary memo – method of preparing can vary, but those with sound control structures prepare a summary checklist or memo memorializing the steps management performed to review each quarter's allowance for credit losses.
  - This would include review of qualitative adjustments and forecast period

# Model Validation & Internal Control Considerations

**Internal control considerations** – Common CECL controls (continued)

- Model Validation – ensure you have obtained a model validation and reviewed prior to adoption date.
  - Prior to the model validation, management should have validated the data being input into the model.

- Service Organization Controls (SOC) Report – if you have utilized a vendor, make sure you are reviewing the SOC report and mapping the Complementary User Entity Controls (CUECs).

# Model Validation & Internal Control Considerations

**Internal control considerations** – Common CECL controls (continued)

- Other considerations:
  - CECL Committee
  - Periodic review of :
    - Appropriateness of peer group
    - Qualitative ranges and weighting
    - Forecast period
    - Period used in developing loss rates
    - Appropriateness of segments and specific methodology applied
  - Disclosure checklist

Note: controls around credit monitoring (i.e. past due, criticized assets, non-accrual, risk rating change, charge-off approval) likely will not change.

# Model Validation & Internal Control Considerations

**Key Takeaways:**

- Assess plans for model validation (commensurate with size and risk profile).
- Manage the vendor.
    - Outsourcing to a vendor does not relieve management of their responsibilities
    - Management should understand the model
- Understand the controls that are necessary for a successful implementation.
    - Maintain organized documentation as necessary (key components during year of implementation may be different than ongoing key components)
    - Update policies/procedures

# Reporting and Disclosure Considerations

## Reporting and Disclosure Considerations (2022 SEC) – Overview

- **SAB 74:** Requires registrants to discuss potential effects of adoption of recently issued accounting standards unless the impact on financial position and results is not expected to be material (unlikely not to be material in relation to CECL).
- SEC expects these disclosures to be updated in filings and for the level of detail to become more robust and quantitative as the implementation date approaches.
- SAB 74 disclosures expected prior to implementation:
  - A comparison of accounting policies
  - Status of implementation
  - Consideration of the effect of new footnote disclosure requirements
  - Disclosure of the quantitative impact of the new standard if it can be reasonably estimated
  - Disclosure that the expected financial statement impact of the new standard cannot be reasonably estimated
  - Qualitative disclosures of the impact on accounting policies when the financial statement impact is not yet known

# Reporting and Disclosure Considerations

**Reporting and Disclosure Considerations (2022 Non-SEC) - Overview**

- GAAP requires the impact of new accounting pronouncements to be disclosed for standards that have been issued, but not effective as of the balance sheet date.
  - Level of and details of disclosure will be dependent on several factors, including the impact to the Bank.
  - Given the timing of adoption (1/1/23) and issuance of financial statements and significance of this standard, in most cases there will be an expectation that discussion of the impact of the adoption on the financial statements will be disclosed.

# Reporting and Disclosure Considerations

**Reporting and Disclosure Considerations – Post Implementation/Adoption (2023) - Overview**

- Institutions should be reviewing requirements to ensure they are prepared for the enhanced financial statement disclosures under CECL.
  - Changes to systems to ensure capture and retention of required data
  - Review and expansion of policies and processes with respect to management's presentation and analysis
  - Review of example disclosures, and modeling of institution specific disclosures to prepare for financial reporting requirements and objectives (required to be included in March 31, 2023 Form 10-Q for SEC filers)
  - Changes will be both quantitative (e.g. – disclosure of amortized cost of financial assets by vintage) and qualitative in nature (e.g. – explanation of inputs used to estimate credit losses and greater detail related to off-balance sheet credit exposures)

# Qualitative Factors Under CECL - Overview

- A company **should not rely solely on past events** (e.g., historical losses)to estimate expected credit losses
- Adjustments to expected losses should be made, where necessary, to reflect the extent to which management expects current conditions to differ from the conditions that existed for the period over which historical information was evaluated
    - Specific factors that reflect changes related to **relevant** data
- Will also be required to consider **reasonable and supportable forecasts of future economic conditions**
    - Not expected to expend undue cost and effort to develop
    - Forecasting inputs may differ among entities, similar to the historical loss rate methodologies used

# Qualitative Factors – Reflection on Incurred Loss Q Factors

- A new credit loss standard presents many banks with a unique opportunity to revisit the qualitative adjustment process
- Qualitative factors require management's most significant and complex judgments in the loss estimation process
- Several pitfalls in current processes for assessing qualitative factors
  - Unsupported adjustments
  - High degree of subjectivity in assessing qualitative factors
  - In practice, negative adjustments to historical losses are rarely used except in the case of unusually large charge-offs that may not be indicative of the losses remaining in the portfolio
    - Specific factors may be significantly improved as compared to the period reflected in the company's historical loss period (e.g., coming out of a recession)
    - May be especially necessary to accurately reflect a company's estimate under CECL

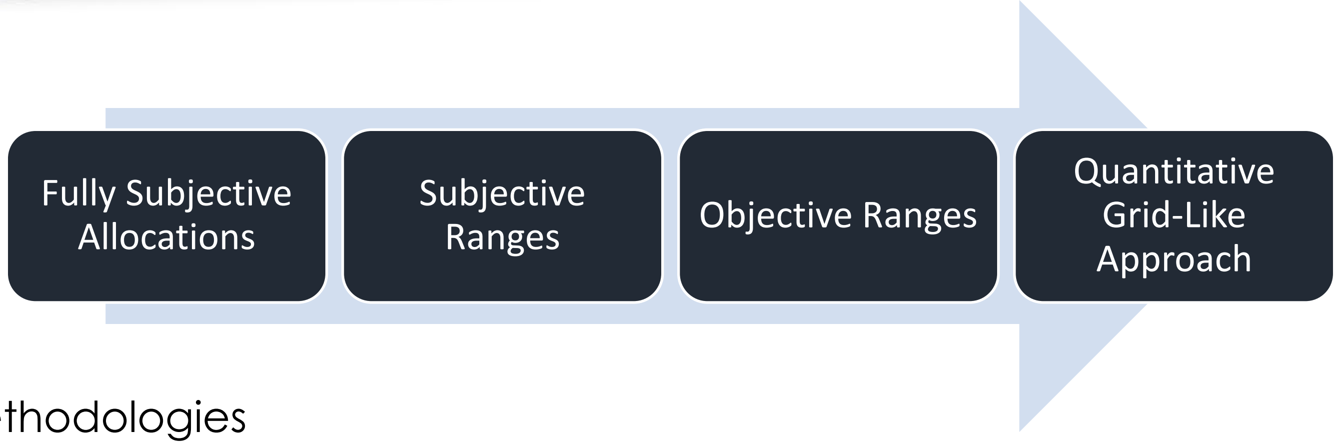
# Q Factors Under CECL - Considerations

- Things to consider
  - Objectivity of assessment process
    - How supportable are your assumptions/allocations?
  - Approach to qualitative factor allocations
    - Macro assessment (i.e., portfolio-wide) vs. segment by segment
  - Specific qualitative factors may or may not be necessary or relevant for a particular portfolio segment
    - Qualitative considerations captured/considered in historical loss calculations
    - Lack of relevance or reliability
      - Loan review for consumer loans
      - Collateral values for C&I loans

# Q Factors Under CECL - Considerations

- Things to consider
  - How the company is considering changes relative to prior periods, current period, and expected changes
    - Evidence required to support q factors
      - Charts/graphing
      - Correlation analysis
      - Moving averages
  - Q factors are not tied to, nor will they be directly related to, incurred loss model q factors
    - What gaps in the model are we covering?
  - The more sophisticated the model, in general, the smaller the adjustments required

# Qualitative Factor Allocation Methodologies




- Qualitative factor methodologies
  - Fully-subjective allocations – Basis point allocations for qualitative factors assigned solely on the basis of management determination with no defined ranges for factors to be assessed.
  - Subjective ranges – Ranges for potential basis point adjustments have been established (e.g. 0-20 basis points); however, the range is not determined using objective data.
  - **Objective ranges – Determined on the basis of underlying data (e.g. 0-15 basis points for each of the 9 qualitative factors). Total maximum of 135 basis points represents the institution's aggregate loss rate for the particular loan pool during the most recent downturn.**
  - **Quantitative grid-like approach – Range of factors assessed are first determined on the basis of underlying data and basis points assessed are assigned based on where the underlying metric falls along the scale (e.g. scale dictates 20 basis points for 5%-6% unemployment; 15 basis points for concentrations of credit that are between 75-100% of capital).**


# Questions?


# Thank You!