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EMERGING ISSUES AND HOT TOPICS

Observations from our Advisory team

2023 Crowe Financial Services Conference

Guide your organization through industry volatility

AGENDA

1 Loan Sales: What to Watch Out For

2 Goodwill Impairment Considerations

3 Loan Modifications, ASU 2022-02

4 Software Capitalization

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LOAN SALES: WHAT TO WATCH OUT FOR

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TRENDS IN LOAN SALES

Why are they important?

- Liquidity constraints and credit concerns could increase loan sale activity in the current economic environment.
- Minor language differences in sales agreement language could lead to different accounting conclusions (sale of an asset vs. a secured borrowing).
- Inconsistent language in participation agreements acquired in acquisitions vs. legacy agreements could result in different accounting treatment.
- If the contract fails sales accounting, it also affects the purchaser and could lead to legal lending limit issues.

These topics generate the most questions and create the most red flags to achieving sale treatment:

Participating Interests

Loan Sales Criteria

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PARTICIPATING INTEREST – LOAN PARTICIPATIONS

- If the entire loan is not being sold, the loan participation must meet the definition of a participating interest to qualify for sales accounting
- A participating interest has all the following characteristics:
  - It represents a proportionate ownership interest in an entire financial asset
  - All cashflows received are divided proportionately among the participating interest holders in an amount equal to their share of ownership after considering cash flows allocated for services performed.
  - Each participating interest shares in all the rights, risks and benefits of the entire loan. No holder can have priority, no interest is subordinate to another, and the holders cannot have recourse to the seller or to each other.
  - No party has the right to pledge or exchange the entire loan unless all participating interest holders agree to the transaction.

IMPORTANT NOTE

Participation agreements may have inconsistent language. Have a process to evaluate individual agreements before applying sales accounting. This is also relevant when participation loans have been obtained through acquisitions.

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THE THREE SALE CRITERIA

Legal Isolation

- The loans have been isolated from the seller—put presumptively beyond the reach of the seller and its creditors, even in bankruptcy or other receivership.

Ability to Pledge or Exchange

- Each buyer has the right to pledge or exchange the loans it receives.
- No condition both 1) constrains the buyer from pledging/exchanging and 2) provides more than a trivial benefit to the seller.

Effective Control

- The seller does not maintain effective control over the loans (e.g., option to repurchase).

Don't Forget

Before you apply the sale criteria…

1) Consider consolidation issues
2) Determine the nature of the transfer (entire asset or portion thereof)
3) Consider all forms of continuing involvement

LEGAL ISOLATION

- If loans are not legally isolated from the seller, the transferred loans could possibly be reclaimed by the seller in the case of bankruptcy or other receivership

CRITICAL Point

Whether the loans have been legally isolated from the transferor is a **LEGAL JUDGMENT**, not an accounting one.

- A true sale opinion from an attorney may be required to support the conclusion that this prong has been met.

- When a legal opinion might **NOT** be needed:
  - The institution has **no** continuing involvement (this means zero, none, zilch, nada)
  - The institution has relevant prior experience with sufficiently similar facts and circumstances
  - The institution has sufficient in-house expertise in bankruptcy law to support an opinion

ABILITY TO PLEDGE OR EXCHANGE

Generally OK

- Right of first refusal held by seller
- Seller must approve subsequent sale, but approval cannot be unreasonably withheld
- Prohibition on sale to seller's competitor if other willing buyers exist

Generally Problematic

- Buyer cannot sell or pledge the loan
- Seller-imposed constraints that narrowly limit terms of any subsequent sale
- Seller must approve any subsequent sale and agreement does not contain language that this approval will not be unreasonably withheld

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EFFECTIVE CONTROL

- Certain terms and features of an arrangement can prevent the buyer from obtaining effective control of the loan.

- Requires institutions to look at the whole picture of the transaction structure and the nature of the relationship between the buyer and seller

- The three big no-no's:
  - Seller has an agreement to repurchase the loans before maturity
  - Seller has the option to repurchase the loans and it provides a more-than-trivial benefit
  - It is probable that the option for the buyer to return the loans to the seller will occur

IMPORTANT NOTE

These are **not** the only ways effective control can be maintained by the seller. Sellers will need to consider the entirety of the facts and circumstances around the arrangement to determine whether effective control has been maintained.

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SUBSEQUENT ACCOUNTING

Accounting for a Sale

1. Derecognize carrying amount of transferred loan(s)
2. Recognize proceeds, including any liabilities incurred, at their fair value
3. Recognize a gain/loss for the difference between 1. and 2.

<u>Things to Remember</u>

- Fair value measurement
- Identify all aspects of consideration, including liabilities incurred

Accounting for a Secured Borrowing

1. Recognize consideration received (cash, other assets) at fair value
2. Recognize a liability equal to the amount of the consideration received
3. Account for the liability as debt (consider need to impute interest)

The loan is <u>not</u> derecognized

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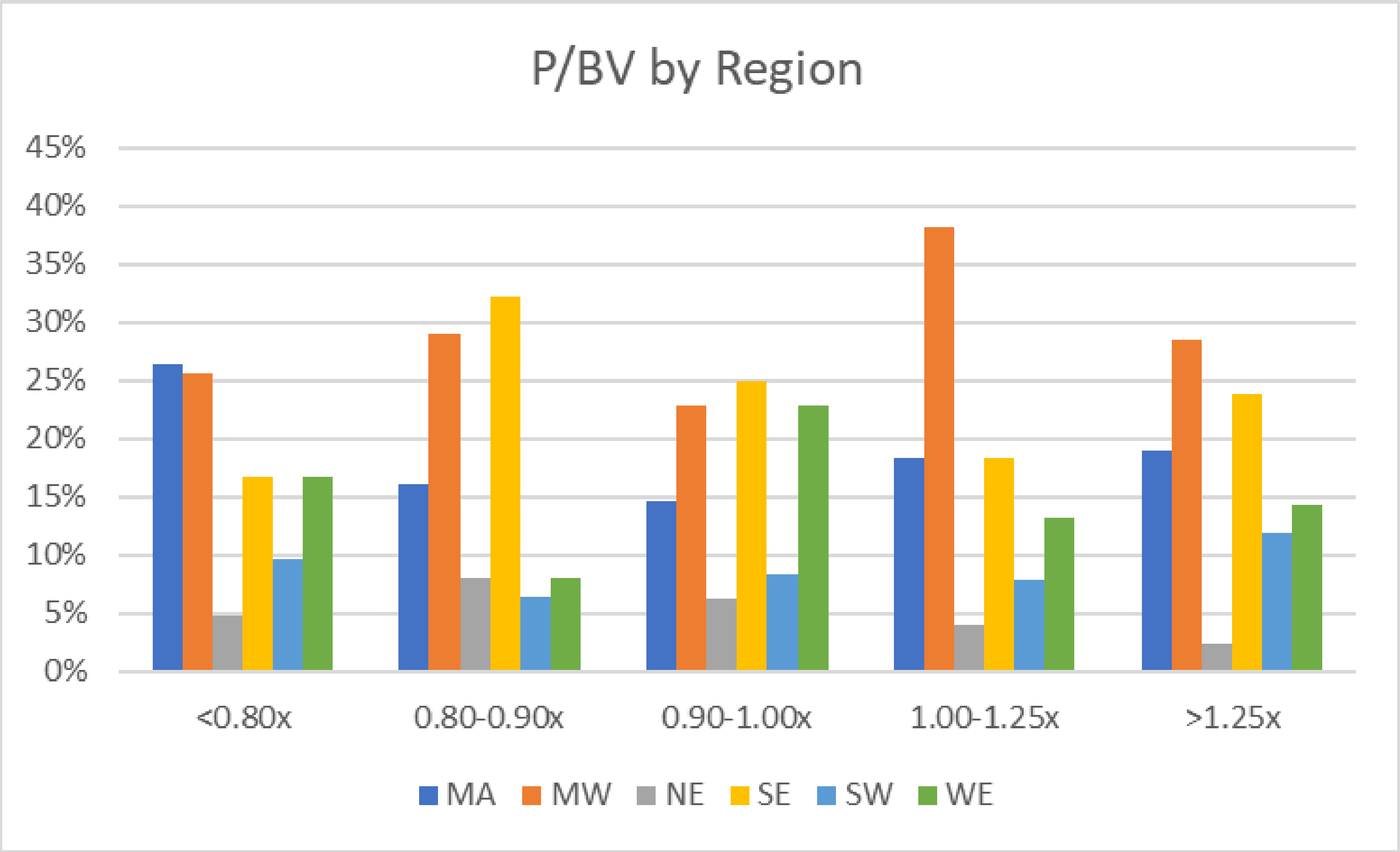
GOODWILL IMPAIRMENT CONSIDERATIONS

GOODWILL IMPAIRMENT – WHY IT MATTERS

- Due to recent declines in bank stock prices and events impacting the banking industry, goodwill impairment assessments have drawn increasing attention.

- The following graph shows how banks by geographic region are trading in comparison to book value as of October 2023.



Source: Crowe analysis of data collected from publicly available filings as of 10.23.23

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GOODWILL IMPAIRMENT EVALUTION

Qualitative vs. Quantitative Analysis

- Stock trading well below book value (around 80% or less)
- Multiple periods of negative cash flow
- Significant declines in liquidity or regulatory capital ratios

Crowe Publication on Goodwill Impairment: https://www.crowe.com/insights/take-into-account/goodwill-impairment-bad-omen-or-good-news

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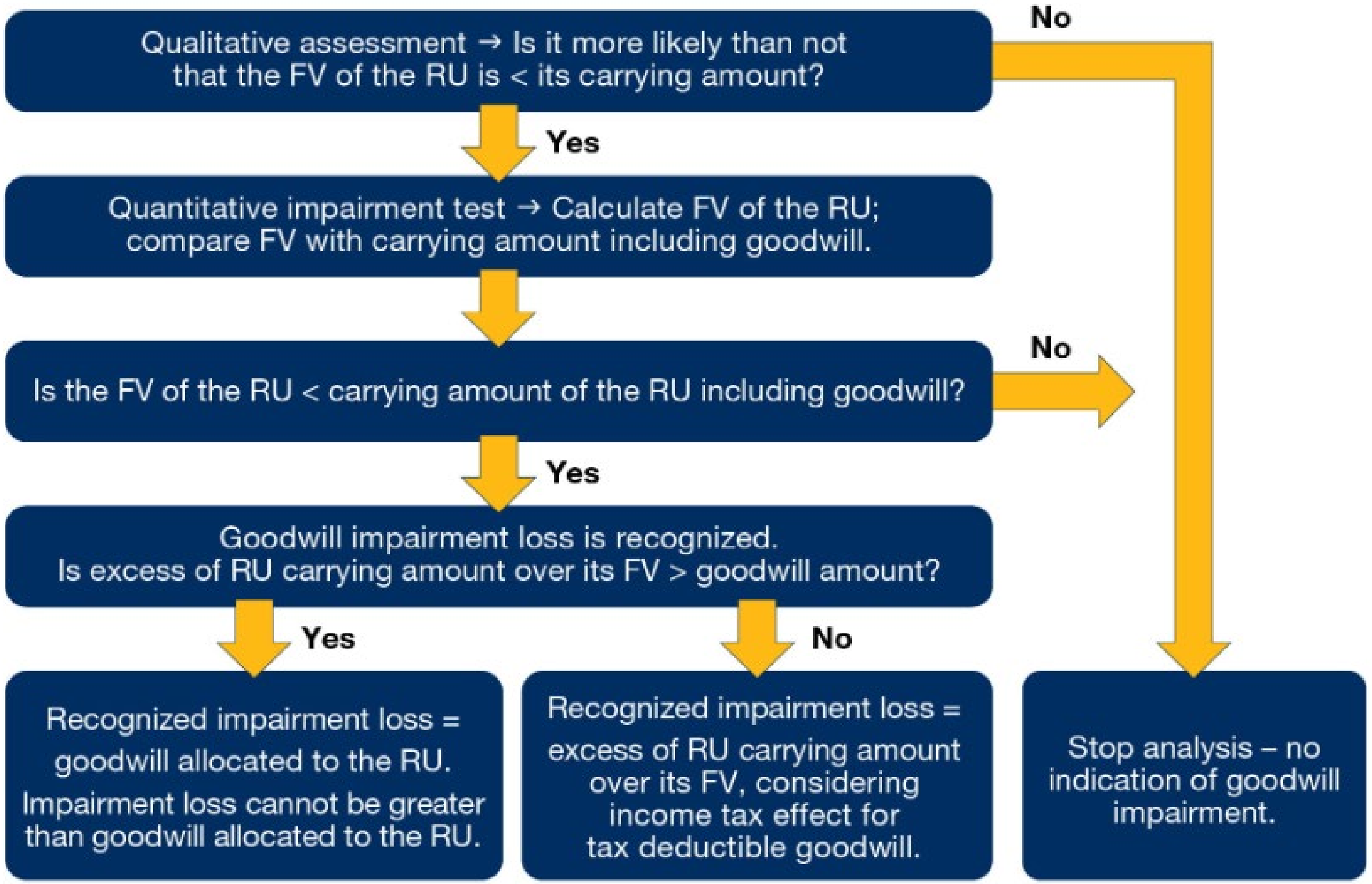
STEPS FOR ASSESSING GOODWILL IMPAIRMENT

The steps for assessing goodwill impairment (whether due to triggering event or annual evaluation) are as follows:



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LOAN MODIFICATIONS, ASU 2022-02

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FAQ ON THE APPLICATION OF ASU 2022-02

Disclosure Triggers

Topics

- Criteria for disclosure
- Determining financial difficulty
- Out-of-scope modifications

New Loan Considerations

Topics

- Disclosure requirements
- Vintage table impacts
- Recognition of deferred fees and costs
- Definition of “more than minor”

Disclosure Nuances

Topics

- Reporting period considerations and examples

Misc.

Topics

- Loan repricing example
- Adoption decisions

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DISCLOSURE TRIGGERS

Disclosure Triggers | New Loan Considerations | Disclosure Nuances | Misc.

Criteria for disclosure (all criteria must be met)

1. Borrower is experiencing financial difficulty
2. Modification is one or more of the following: principal forgiveness, interest-rate reduction, other-than-insignificant payment delay, term extension

Determining financial difficulty

- Legacy TDR guidance is unchanged. Judgment is required in determining if a borrower is experiencing financial difficulty.

Out-of-scope modifications

- Covenant waivers, collateral substitutions, changes in guarantors

Helpful Guidance

- 310-10-50-38 through 50-41

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NEW LOAN CONSIDERATIONS

Disclosure Triggers | New Loan Considerations | Disclosure Nuances | Misc.

Definition of "more than minor"

- If the present value of cash flows under the new and old terms is more than 10% different, the modification is considered "more than minor."

Disclosure requirements

- If a new loan results from a modification to a borrower experiencing financial difficulty, disclosure is required.

Vintage table impacts

- If a modification results in a new loan, the origination year would be updated accordingly in the vintage table.

Recognition of deferred fees and costs

- New loans: Unamortized fees or costs, and prepayment penalties from the original loan recognized in interest income.
- Not a new loan: Deferred fees and costs shall continue to be amortized over the remaining life.

Helpful Guidance

- ASC 310-20-35-9 through 35-11

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DISCLOSURE NUANCES

Reporting period considerations

- Disclosure as of the balance sheet date is required for modifications made during income statement periods presented.
- Quantitative and qualitative information about modifications within the prior 12 months are required for each income statement period presented.

Helpful Guidance

- 310-10-50-42 through 50-44

Example

- Assume a calendar year-end reporting company executes a qualifying modification to a borrower in financial distress on June 1, 2023. The loan's performance will be disclosed in the following periods:

Q2 '23 → Q3 '23 → 2023 FS → Q1 '24

MISCELLANEOUS

New Loan Considerations | Disclosure Triggers | Disclosure Nuances | Misc.

Loan repricing example

- A loan has a current rate of 4%. In anticipation of the loan repricing to 8% in 2024, the loan is modified in Q4 2023 to a rate of 6% and the next repricing date is extended. Does this qualify as a loan mod that would trigger disclosure?
  - It depends – consider if repriced to 8%, would the borrower be in financial distress? If so, yes.

Adoption decisions

- Prospective adoption: Continue estimating ACL for existing TDRs using a DCF approach.
- Modified retrospective: Estimate ACL under CECL for existing TDR loans. Any change in ACL is recorded through retained earnings in the period of adoption.

<u>Note: Legacy TDR disclosures are no longer required to be disclosed. Comparative disclosures are no longer required under 2022-02.</u>

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SOFTWARE CAPITALIZATION

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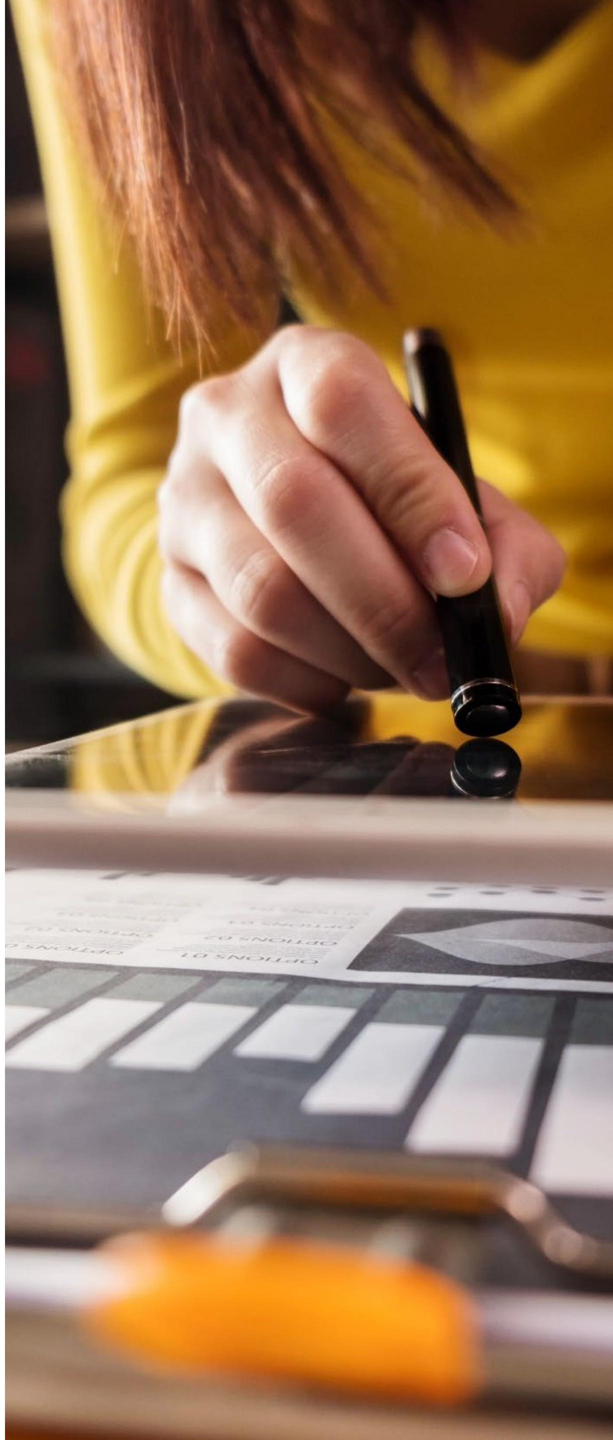
SOFTWARE CAPITALIZATION

FAQ:

1. When should I expense or capitalize software costs?
2. What are the differences between a cloud computing arrangement (CCA) and internal use software?

CCA:
Typically, a fee is paid for access to software via the internet (SaaS model).

Internal-use software:
Software purchased or internally developed for operational use.



TYPES OF COSTS

Cost recognition, for both internal-use software and CCAs, is dependent upon the stage of the project, as described in ASC 350-40-25-1 through 25-6:

Preliminary project stage **Expense as incurred**	Application and development stage **Capitalize****	Post-implementation stage **Expense as incurred**
• Strategic decisioning and exploratory research • Selection of a vendor • Engagement of a consultant for assistance	• Costs for software to assist in data conversion • External direct costs of materials and services • **Actual data conversion/migration and employee training costs should be expensed as incurred	• Internal and external training costs • Maintenance costs

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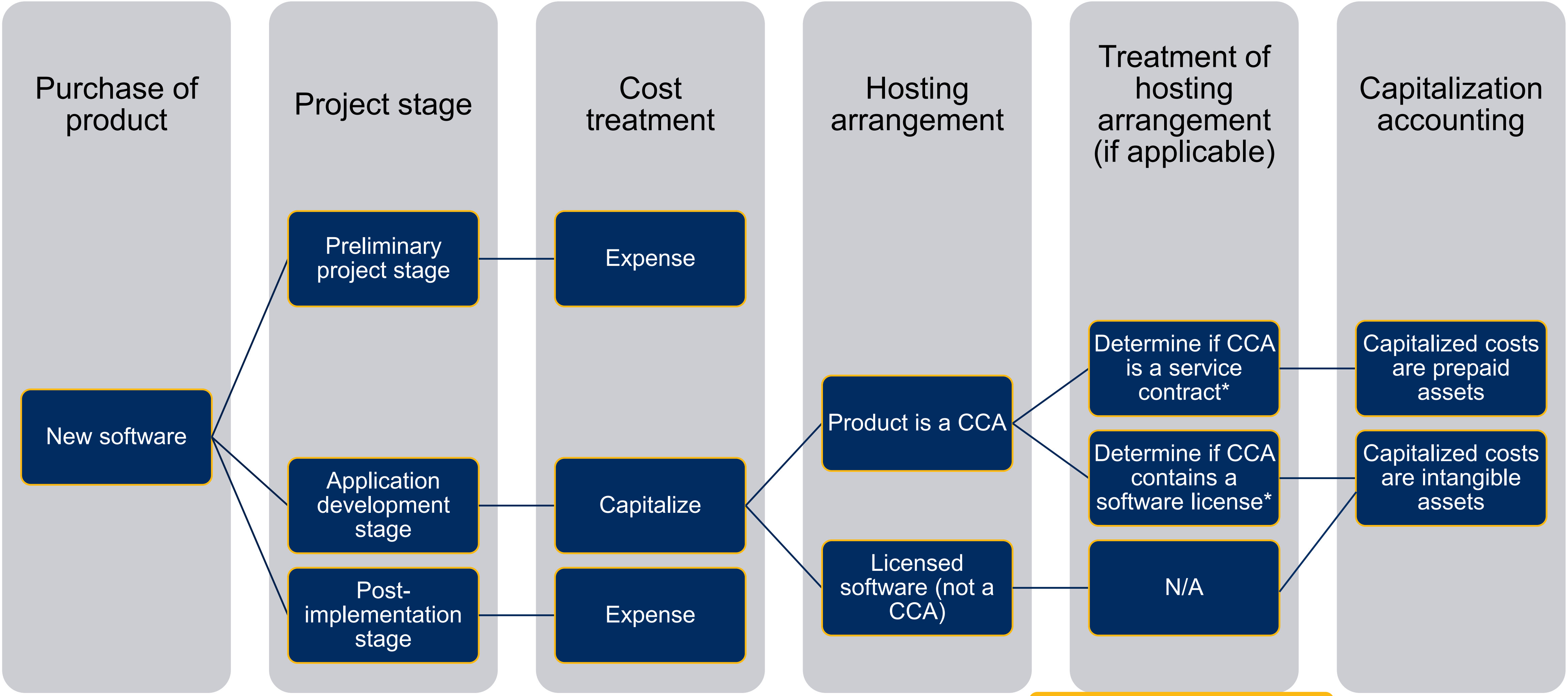
SOFTWARE CAPITALIZATION COSTS

The asset recognized for capitalized costs is dependent on the type of software obtained.



*Refer to ASC 350-40-15-4A through 15-4C

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OTHER SOFTWARE CAPITALIZATION REMINDERS

Impairment triggers

- Software/Service contract is not providing service potential
- A significant change is made or there is a change in its expected use
- For internal-use software only, if costs to develop or modify software exceed initial expectations

Considerations for payroll-related costs

- Significance
- Operational challenges in tracking

How are capitalized costs treated in a business combination?

Acquired software intangibles that can be separated from the business are remeasured at fair value, assuming their highest and best use

- Typically valued using either replacement/build up cost or the relief from royalty method
- A CCA intangible asset should be reported separately from other acquired software
- For CCA contracts with off-market terms, a separate “favorable contract asset” or “unfavorable contract liability” should be recorded

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QUESTIONS?

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