Crowe Horwath.

Understanding M&A Accounting: What to Watch For

By Rick Childs and Chad Kellar

One of the worst things for an acquirer to find out after the fact is that the target wasn't worth what the acquirer thought it was. That egg is on the board's face and can cause significant headaches. The following are key trends and issues we have found recently in merger and acquisition (M&A) due diligence reviews.

Asset Quality

There is no better indicator of credit quality than a thorough loan review. We have seen a significant rise in collateral values in areas that were the hardest hit and modest recovery in others. Once-troubled institutions are recovering and finally are beginning to move other real estate owned and problem loans that sat unmarketable for several years. While the cleanup might not lead to a recapitalization of a bank for a variety of financial and legacy reasons, it has positioned many institutions as attractive acquisition targets at reasonable franchise values.

However, the not-so-happy news is that weak loan demand and the need to deploy capital efficiently have led to easing credit standards in commercial and industrial (C&I) and commercial real estate loans. It is important to check for deficiencies such as borrower base certificate compliance, waived or reset covenants, and lack of field audits. Also, current underwriting with extended amortizations and lower debt service requirements can present long-run risk to an acquirer. Additionally, we see institutions engaging in new loan products, which can present long-term risk if lender qualifications and track records have not been tested through a variety of economic cycles.

Quality of Earnings and Balance Sheet

Tangible book value (TBV), a common metric within the financial services industry, is used as an anchor for pricing a potential acquisition. Understanding the ways in which improper accounting or one-time income or expense items may skew this figure is important in arriving at a proper value for the bank. In the private company setting, we often find the rigor applied to interim accounting records does not match that applied to the annual audited financials. As management teams are more focused on normalizing yearly results, non-operating expense items might level out over the course of the year to not dramatically affect monthly results. We've observed a number of improperly capitalized items buried in other assets and underaccrued liabilities that can significantly distort the net book value of a bank. When establishing a fair purchase price based on a multiple of TBV, a $1 million interim balance sheet misstatement could mean a $1.5 million to $2 million purchase price adjustment.

Crowe Horwath.

Similarly, a $100,000 overstatement of core earnings could be a $1.6 million to $2 million purchase price adjustment using current multiples. We continue to see earnings supported by reserve releases, investment security sales, and various other anomalies that have to be deciphered in order to get a true picture of normalized earnings. Determining a bank's core earnings potential is more difficult in the current landscape because many acquisition targets have completed bank acquisitions of their own in the past few years. Both open-bank and failed-bank acquisitions come with accounting complexities related to recognition of interest income on the loans acquired. It's imperative to understand the difference between the accounting yields and the cash income created from these acquired assets in order to avoid overestimating core earnings.

If a target bank has completed a failed-bank acquisition with loss-share agreements in place, significant consideration should be given to the accounting and record keeping of the loss-share arrangement. Acquirers should focus on understanding the remaining terms of any loss sharing, the ability to collect under the loss-share terms, and the potential hole that might be created from overstatement of the indemnification asset. Many of these arrangements may not be completely settled with the Federal Deposit Insurance Corp. (FDIC) for several more years, and many agreements contain a "true-up" provision whereby the FDIC could be owed significant sums of money if the loans perform better than expected. Each loss-share contract is unique, and potential acquirers need to fully understand the complexities associated with these agreements during the due diligence phase.

The issues highlighted here are just a few of the more common issues we're seeing in current due diligence findings. Execution of a well-conceived due diligence plan can help eliminate surprises from an accounting, operational, and credit perspective and lead to a successful transaction.

Contact Information

Rick Childs, a director in Crowe Horwath LLP's financial advisory services group, has been with the firm for 25 years. He can be reached at 317.706.2654 or at rick.childs@crowehorwath.com.

Chad Kellar is a senior manager at Crowe Horwath LLP in Indianapolis. He can be reached at 317.208.2431 or chad.kellar@crowehorwath.com.

This article was published by Bank Director in September 2014 and is reproduced with permission.

Crowe Horwath LLP is an independent member of Crowe Horwath International, a Swiss verein. Each member firm of Crowe Horwath International is a separate and independent legal entity. Crowe Horwath LLP and its affiliates are not responsible or liable for any acts or omissions of Crowe Horwath International or any other member of Crowe Horwath International and specifically disclaim any and all responsibility or liability for acts or omissions of Crowe Horwath International or any other Crowe Horwath International member. Accountancy services in Kansas and North Carolina are rendered by Crowe Chizek LLP, which is not a member of Crowe Horwath International. This material is for informational purposes only and should not be construed as financial or legal advice. Please seek guidance specific to your organization from qualified advisers in your jurisdiction. © 2014 Crowe Horwath LLP

FS15902-6A