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Financial Institutions Insights

A timely information and idea statement

Financial instruments: In-depth analysis of new standard on credit losses

By: Faye Miller and Mike Lundberg

Download white paper

In June 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. Our white paper, Financial instruments: FASB issues new standard on credit losses, provides entities with answers to the following key questions:

- Who is affected by the new guidance? In other words, what entities must apply the new guidance?
- How are credit losses related to the following accounted for under the new guidance:
  - Financial assets measured at amortized cost (e.g., held-to-maturity debt securities, loans, accounts receivable)?
  - Off-balance-sheet credit exposures?
  - Available-for-sale debt securities?
- How does the new guidance compare to existing guidance?
- What disclosures are required under the new guidance?
- When must the new guidance be applied?
- What method must an entity use to transition to the new guidance?
- What should entities be doing now to prepare for implementation of the new guidance?

While the new guidance is not effective for some time, entities should not wait to understand the new guidance and the effects it will have on the financial statements. Obtaining that understanding sooner rather than later will provide for a smoother transition and allow for more timely communications with stakeholders about how the new guidance will affect the financial statements. Use our white paper to start obtaining the understanding you need.

Tax planning considerations for a future sale or purchase of a bank

By: Doug Jenen and Frank O'Connor

For the past several years there has been a consistent wave of mergers and acquisitions within the banking industry. There are many reasons why the banking industry continues to shrink but clearly the trend is expected to continue for the foreseeable future. While only a handful of new bank charters have been approved on a national basis in the past five years, the pace of consolidation has averaged 270 deals per year. From a percentage basis, this translates to 4.5 percent of total U.S. bank charters disappearing each year.

With all this M&A activity and excitement, it's likely that your bank is at least considering either a sale of the company or actively looking for strategic acquisitions to grow your balance sheet. While tax should never be the only driver of a business decision you make, it certainly should be heavily considered. RSM would like to help your planning by releasing a series of banking industry focused M&A tax articles to guide you through the potential tax challenges and road blocks that you may encounter.

Over the next several months, we will take an in-depth look into various tax related current topics and developments related to banking M&A. The emphasis of our M&A tax series will be on what your bank can do and plan for in advance of a deal to either position your bank to maximize your value to a prospective acquirer or protect your bank from surprises with respect to the acquisition of a target.

Pre-merger or pre-acquisition tax planning and considerations

Whether your bank is a potential target or a potential buyer, it always makes sense to plan ahead from a tax perspective (i.e. "getting your house in order"). Negotiating a deal can be a time consuming and costly exercise as it is. If you anticipate that you might be pursuing a deal in the next year or so, tax planning in advance is a smart idea to maximize shareholder value and to avoid any tax pitfalls or unnecessary marks to your purchase price which could pop up during deal negotiations.

First and foremost, both the buyer and seller should consider the form or substance of the transaction that suits each party best from both a structuring perspective and from a tax perspective.

Tax planning, continued on page 2

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Tax planning, continued from page 1

In different situations, it may make sense to structure a deal as a sale of assets and sometimes as a merger sale of stock or both. In many instances, other business reasons drive this decision.

As a seller, there are several items to consider. It is important that you step back and perform a tax due diligence analysis on yourself. Do you have any uncertain tax positions (ASC 740-10) that may have not been disclosed properly which would be discovered in the due diligence process by the buyer? These positions could represent unrecorded contingent liabilities from future IRS and State audits. Do you have any other tax exposures such as sales and use, city or property taxes that need to be resolved? Are you filing an income tax return in every state that you should be filing in given the complex state nexus requirements (if not, the statute of limitations on a potential tax assessment never closes)?

In addition, you may want to execute strategies to obtain more value from a buyer for your deferred tax assets. Will there be a "change in control" event upon the sale under section 382 which would limit the use of your tax attributes by the buyer? Will a buyer thus pay you full value for such deferred tax assets or will they adjust downward their proposed purchase price? It may be in your best interest to sell appreciated assets or modify tax accounting methods to accelerate taxable income to utilize key deferred tax assets prior to expiration and limitation in value to the buyer.

A buyer of course will want to perform a due diligence review of any target they are considering as well. Any potential limitation on deferred tax assets to be acquired such as net operating losses, unrealized built-in losses and tax credit carry-forwards (under section 382) should be analyzed prior to the purchase price negotiation process. The IRS recently changed how they compute the Applicable Federal Rate (AFR) which is used in computing the limitations imposed on use of tax attributes by a buyer. This change may decrease the future utilization of tax attributes by 25 percent (where section 382 applies) starting in September 2016. It's even more critical that a buyer understands the true economic value of the deferred tax assets being purchased.

Another key area both the buyer and seller should review is their transaction costs, including investment banker success based fees, legal fees, consulting fees and due diligence investigation fees for opportunities to deduct what otherwise may be required to be capitalized for tax purposes.

Finally, one other key tax area of discussion between buyer and seller which we will explore in greater detail in future articles involves executive management contracts, severance payments and any change in control payments resulting from a proposed transaction. From a tax perspective we have certain "golden parachute" tax provisions. The tax golden parachute limitations on tax deductibility and possible individual excise tax penalties may materially impact the final purchase price on a per share basis.

Both the buyer and seller should review any of these types of preacquisition tax liabilities being assumed by the buyer or being paid at closing. The timing of these payments and the timing of the deductions on the seller's final tax return or in the buyers post-transaction tax returns may present tax planning opportunities which should be considered.

Overall, both the buyer and seller should consult with their tax advisors to make sure each party understands how the deal is structured and the tax impact to buyer, seller and their respective shareholders.

Purchase accounting tax considerations

One challenging key area is the "day one" opening purchase accounting entries on the financial statements of the buyer and how the tax considerations need to be reflected on the day one balance sheet. In a taxable stock purchase or tax-free merger, the tax basis of the various assets and liabilities of the target generally carry over. Does the acquirer have enough information to adequately revalue the various deferred tax assets and liabilities acquired based on the purchase account fair market value marks? Are the deferred tax inventory records of the target adequate or do certain items need to be validated? Does the acquirer have enough information to compute any potential tax attribute limitations under the section 382 change in control rules? Should a valuation allowance be considered on certain net operating losses which might be expiring soon? The acquirer's day one balance sheet must address the buyer's determination of the overall adequacy of the target's tax reserve accounts whether they be deferred tax assets or tax reserves for future tax exposures related to contingent tax liabilities. The risk is that typically a buyer only has a short window of time to set their purchase accounting in stone.

Post-merger tax planning and considerations

We typically bear witness to the lack of proper tax planning that acquirers have to deal with once a deal has closed. As a buyer, it is generally advisable to have a tax game plan in case issues pop up post-closing. In addition, the buyer should pay special attention to preserving all key tax historical data. In particular, the source general ledger data for all tax information supporting the prior tax returns whether prepared internally or by a third-party accounting firm.

In addition, careful consideration should be taken into which accounting firm or internal tax department will assist with the final tax return of the target. Will the acquirer be allowed to review such final tax filings and provide feedback prior to the filing? Do both parties agree with the tax positions taken? Are there expenses that should really be deducted on the tax return of the acquirer? Should the target forgo tax deductions on the final return to increase the use of tax attributes to limit potential section 382 limitations on the use of those attributes by the buyer?

Conclusion

We're sure that your head may be spinning with all of the considerations to think about. Every deal is unique so not all of these considerations may apply to your individual situation. That said, we do strongly encourage you to hire a tax advisor that can guide you through this process. With proper planning in advance, it is possible that the company can save significant dollars from a tax perspective and improve shareholder value on the deal. Please look for our next article in the series which will begin with a deeper discussion into pre-deal planning in the upcoming months.

Top 5 IT budget considerations for financial institutions

By: Bryan Nelson

The current atmosphere is challenging for financial institutions, as increasing regulatory demands and the rising costs of doing business are making profitability more difficult. As your institution begins the budgeting process, your IT framework will likely come under scrutiny, as properly leveraging technology can help you become more efficient while providing necessary security measures. Below are five key questions to evaluate closely during budgeting season to help ensure you stay in compliance and are getting the most from your IT investments.

1. **Is a virtual CIO right for your institution?**

   With technology utilization a key element in your institution's efficiency, security and overall success, the insight and knowledge of a senior technology executive have become essential. However, many institutions either do not have the resources for, or have never hired, an internal chief information officer (CIO) to develop strategy and bridge the gaps between executives and the IT staff.

   However, a virtual CIO from an external provider can bring more value than a traditional CIO with less cost, as you only leverage resources and experience as needed. A virtual CIO brings the skills, tools and experience necessary to align technology with your business and compliance needs, without the need for the expenses related to a full-time employee and benefits.

2. **How are you using the cloud?**

   The cloud presents several opportunities for your financial institution, and you must ensure that you leverage it to its full capabilities. An effective cloud strategy can increase your access and mobility potential, and can greatly enhance disaster recovery capabilities with entire systems and servers or backups securely stored off-site.

   A cloud assessment can help your institution determine how you compare to peers, whether you are taking advantage of the most up-to-date cloud services and technology, and how you can potentially utilize the cloud to strengthen security measures, boost efficiency and ultimately increase profitability.

   Download our e-book to learn more about defining your cloud strategy.

3. **Is your cybersecurity stance effective?**

   Cybersecurity risks are a significant driver behind many new compliance guidelines, and your technology infrastructure must keep pace to protect your sensitive data. The FFIEC's Cybersecurity Assessment Tool is a standardized framework to determine whether you have thorough cybersecurity measures in place by assessing your level of inherent risk and also measuring the strength and maturity of your cyber controls.

   Read our recent article to learn how to make the most of the FFIEC's Cybersecurity Assessment Tool.

   In addition, to better protect your institution and manage resources, you should implement a layered security approach, viewing your IT framework as an ecosystem. Too often, institutions focus on protecting the perimeter of their technology systems, and add patches or address threats as they are noticed; this approach is not efficient and can result in additional vulnerabilities. Instead, focusing security at multiple layers better detects and remediates threats while increasing efficiency.

4. **Do you have an effective SIEM tool in place?**

   Institutions need to have tools in place to monitor their network and to identify and respond to suspicious behavior and any unauthorized activity. A Security Information and Event Management (SIEM) framework helps to monitor activity, analyze results and respond to any security events to reduce risks to customers and the institution as a whole.

   A SIEM solution is essential to stay in compliance with evolving regulatory demands, but it also enhances several key areas of the institution such as configuration, log and inventory management, as well as application and performance monitoring.

5. **Are your vendor management processes efficient?**

   Outsourcing has become a widely utilized strategy for all institutions, leveraging vendors for a growing number of processes, including some that handle sensitive customer data. However, regulatory guidelines are becoming more extensive for external vendors, and outsourcing the function does not outsource the responsibility. Vendor strategies are not always efficient, and it's important to remember that your institution will be held liable for a vendor's system failures or breaches that expose data.

   To improve vendor processes from a financial and regulatory perspective, many institutions are outsourcing compliance responsibilities to an external vendor, or implementing vendor management software. These solutions can help your institution implement more effective, compliant, and most importantly, secure, vendor management processes at a defined and manageable cost.

   Your institution should evaluate vendor relationships with a risk assessment, focused on key areas such as:

   - Performing due diligence on the vendor
   - Determining whether it has had a cybersecurity review
   - Evaluating its business continuity plan
   - Ensuring your institution has the right to audit the vendor
   - Reviewing cybersecurity documentation as well as any agreements vendors have made with additional third parties that may handle your information.

Remember that your security efforts are only as effective as your weakest link, and that may be one of your vendors.

To read more, go to: http://rsmus.com/our-insights/newsletters/financial-institutions-insights/top-5-it-budget-considerations-for-financial-institutions.html

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