

may differ in their systematic approaches to such estimation. Nevertheless, assuming that appropriate methodology (*i.e.*, giving due consideration to all relevant facts and circumstances affecting collectibility) is followed by each bank, the staff believes that each bank's estimate of the uncollectible portion of Bank B's loan portfolio should fall within a range of acceptability. That is, the staff believes that the uncollectible portion of Bank B's loans as estimated separately by the two banks ordinarily should not be different by an amount that is material to the financial statements of Bank B and, therefore, an adjustment to the net carrying value of Bank B's loan portfolio at the acquisition date to reflect a different estimate of uncollectibility ordinarily would be unnecessary and inappropriate.

However, a purchase accounting adjustment to reflect a different estimate of uncollectibility may be appropriate where Bank A has plans regarding ultimate recovery of certain acquired loans demonstrably different from the plans that had served as the basis for Bank B's estimation of losses on those loans.² In such circumstances, Bank B's estimate of uncollectibility for those certain loans may be largely or entirely irrelevant for purposes of determining the net carrying value at which those loans should be recorded by Bank A. For example, if Bank B had intended to hold certain loans to maturity but Bank A plans to sell them, the acquisition cost allocated to those loans should equal the value that currently could be obtained for them in a sale.³ In that case, Bank A would report those loans as assets held for sale rather than as part of its loan portfolio, and would report them in postacquisition periods at the lower of cost or market value until sold.

The staff does not intend to suggest that an acquiring bank should record acquired loans at an amount that reflects an unreasonable estimate of uncollectibility. If Bank B's financial statements as of the acquisition date are not fairly stated in accordance with

generally accepted accounting principles because of an unreasonable allowance for loan losses, that allowance for loan losses should not serve as a basis for recording the acquired loans. Rather, Bank B's preacquisition financial statements should be restated to reflect an appropriate allowance, with the resultant adjustment being applied to the restated preacquisition income statement of Bank B for the period(s) in which the events or changes in conditions that gave rise to the needed change in the allowance occurred.

6. Debt Issue Costs

Facts: Company A is to acquire the net assets of Company B in a transaction to be accounted for as a business combination. In connection with the transaction, Company A has retained an investment banker to provide advisory services in structuring the acquisition and to provide the necessary financing. It is expected that the acquisition will be financed on an interim basis using "bridge financing" provided by the investment banker. Permanent financing will be arranged at a later date through a debt offering, which will be underwritten by the investment banker. Fees will be paid to the investment banker for the advisory services, the bridge financing and the underwriting of the permanent financing. These services may be billed separately or as a single amount.

Question 1: Are all fees paid to the investment banker a direct cost of the acquisition and, as such, accounted for as an element of the purchase price of the business acquired?

Interpretive Response: No. Fees paid to an investment banker in connection with a business combination, when the investment banker is also providing interim financing or underwriting services, must be allocated between direct costs of the acquisition and debt issue costs.

Statement 141 provides that direct costs such as finder's fees and fees paid to outside consultants should be treated as components of the cost of the acquisition, while the costs of registering and issuing any equity securities are treated as a reduction of the otherwise determined fair value of the equity securities. However, debt issue costs are an element of the effective interest cost of the debt, and neither the source of the debt financing nor the use of the debt proceeds changes the nature of such costs. Accordingly, they should not be considered a direct cost of the acquisition.

The portions of the fees allocated to direct costs and to debt issue costs

should be representative of the actual services provided. Thus, in making a reasonable allocation (or in determining that an allocation made by the investment banker is reasonable¹ factors such as (i) the fees charged by investment bankers in connection with other recent bridge financings and (ii) fees charged for advisory services when obtained separately, should normally be considered to determine the relative fair values of the two services. Whether these or other factors are considered, the allocation should normally result in an effective debt service cost (interest and amortization of debt issue costs² which is comparable to the effective cost of other recent debt issues of similar investment risk and maturity. The amount accounted for as debt issue costs should be separately disclosed, if material.¹

Question 2: May the debt issue costs of the interim "bridge financing" be amortized over the anticipated combined life of the bridge and permanent financings?

Interpretive Response: No. Debt issue costs should be amortized by the interest method over the life of the debt to which they relate. Debt issue costs related to the bridge financing should be recognized as interest cost during the estimated interim period preceding the placement of the permanent financing with any unamortized amounts charged to expense if the bridge loan is repaid prior to the expiration of the estimated period. Where the bridged financing consists of increasing rate debt, the consensus reached in EITF Issue 86-15 should be followed.⁴

7. Loss Contingencies Assumed in a Business Combination

Facts: A registrant acquires a business enterprise in a business combination. In connection with the acquisition, the acquiring company assumes certain contingent liabilities of the acquired company.

Question: How should the acquiring company account for and disclose contingent liabilities that have been assumed in a business combination?

¹ This would apply irrespective of whether the fees for the services were billed as a single amount or separately, since the separate billing of the services implicitly involves an allocation by the investment banker.

² See Question 2 regarding the period over which the debt issue costs related to bridge financings should be amortized.

³ See Rule 5-02(17) of Regulations S-X.

⁴ As noted in the "Status" section of the Abstract to Issue 86-15, the term-extending provisions of the debt instrument should be analyzed to determine whether they constitute an embedded derivative requiring separate accounting in accordance with Statement 133 (as amended).

² A bank's plans for recovering the net carrying value of certain individual loans or groups of loans may differ from its plans regarding other loans. The plan for recovering the net carrying value of a loan might be, for example, (a) holding the loan to maturity, (b) selling it, or (c) foreclosing on the collateral underlying the loan. The assigned value of loans should be based on the plan for recovery.

³ It is not acceptable to recognize losses on loans that are due to concerns as to ultimate collectibility through a purchase accounting adjustment, nor is it acceptable to report such losses as "loss on sale." An excess of carrying value of Bank B's loans over their market value at the acquisition date that is due to concerns as to ultimate collectibility should have been recognized by Bank B through its provision for loan losses.