Financial Services

# Banking Sector M&A — What You Need To Know Now

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# CONTENTS



## Thank you for downloading our eBook, Banking Sector M&A — What You Need to Know Now.

We hope it serves as a valuable resource as you navigate M&A in these uncertain times.

It's essential for financial institution stakeholders to stay informed about M&A, even if they aren't currently involved in the process. By continuously educating your team and thoroughly exploring the key aspects of M&A, you'll gain a more comprehensive understanding. This eBook is designed to guide you step by step through certain aspects of the banking sector M&A process, highlighting important tax, accounting, legal, and operational considerations along the way.

At The Bonadio Group, we provide innovative services to banks, credit unions, mortgage companies, and investment firms, offering specialized expertise to meet your unique challenges. Our Financial Services team is made up of professionals with extensive experience working in financial institutions or dedicated to serving them. This enables us to share practical, relevant insights tailored to your needs.

If you have any questions, please don't hesitate to reach out. We're here to help and look forward to connecting with you.

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01

# Banking Sector M&A Process


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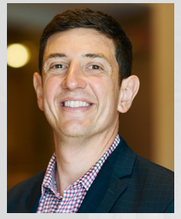

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## Key Phases in the Sell-Side M&A Process: A Six-Step Approach for Financial Institutions

**This six-step M&A process minimizes disruption, maintains confidentiality, and maximizes after-tax proceeds.**

### 1 Assessment

- Determine goals and objectives/review alternatives
- Preliminary market research and benchmarking
- Estimate preliminary valuation range
- Discuss due diligence readiness

### 2 Planning and Preparation

- Engage advisors and assemble team
- Internal due diligence to identify (and correct) potential issues
- Determine potential buyers and marketing strategy
- Prepare information memorandum (and related documents)

### 3 Marketing

- Initiate contact with potential buyers
- Communicate bidding process
- Distribute offering materials
- Coordinate (preliminary) information requests

### 4 Deal Making

- Receive offers
- Establish precise deal terms
- Analyze and negotiate simultaneously
- Select winning offer

### 5 Due Diligence

- Coordinate due diligence
  - Financial
  - Operational
- Shareholder/depositor approval
- Address issues and negotiate deal impact

### 6 Transaction Documents and Closing

- Negotiate definitive agreements (addressing issues that arise)
- Coordinate satisfaction of deal contingencies
- Close
- Post-closing true-ups

**Regulatory Communications and Approvals**

# Preparing for a Sale: Go-To-Market Readiness

When assessing go-to-market readiness, various qualitative factors that represent potential valuation enhancers and detractors, present in virtually every financial institution should be evaluated. These factors should be assessed through the lens of potential buyers to determine how they may perceive the potential risks and rewards of ownership, and to understand the general attractiveness of the business in terms of a potential investment decision. The results of this evaluation are combined with the other considerations to assist in determining next steps, including whether to pursue an exit in the near term.

### Potential Valuation Enhancers and Detractors:

#### General:

- Regulatory Compliance
- Operational Efficiency
- Profitability
- Legal Considerations
- Growth potential

#### Financial:

- Strong financial statements (at least three years of audited financial statements)
- Profitability and Efficiency metrics (ROA, ROE, NIM, etc.)
- Capital Adequacy
- Loan Portfolio Quality
- Liquidity Position

#### Customer and Market:

- Customer base
- Market share
- Product mix
- Brand and Reputation

#### Competition:

- Amount of competition
- Barriers to entry (institution-specific differentiators)

#### Management and Employees:

- Management quality
- Reliance key personnel
- Management transition desires
- Employee availability
- Employee retention / turnover



# Intro to Quality of Earnings

In the world of mergers and acquisitions ("M&A"), the term "Quality of Earnings," or "QoE," holds significant importance for sellers, potential buyers, and other stakeholders. While many potential sellers are not familiar with QoE reports before exploring a potential M&A transaction, they should be. In this article we will delve into Quality of Earnings reports, discuss what they entail, when they occur, who requires them, and why they have become an essential part of M&A deals.

### What is a QoE?

At its most basic level, a QoE report is part of the financial due diligence surrounding a potential M&A transaction. A QoE report is a formal third-party analysis that provides an in-depth analysis of the institution's earnings, helping both the seller and potential buyers gain a clearer understanding of the true financial performance. Here's why it is important:

#### Enhances Transparency and Credibility

A QoE report ensures that earnings are clearly defined and properly adjusted for one-time or non-recurring items, providing an accurate picture of the institution's sustainable earnings. This transparency builds credibility with potential buyers and speeds up the due diligence process.

#### Identifies Potential Red Flags Early

By conducting the QoE upfront, the seller can identify any potential accounting or financial issues that may raise red flags for buyers. Addressing these proactively helps avoid surprises during the buyer's due diligence and can prevent valuation adjustments or renegotiations.

#### Optimizes Valuation

Having a QoE report gives the seller a solid foundation to support their valuation and defend against buyer attempts to discount the price based on perceived earnings volatility or risks. It helps to counter any claims of inflated earnings or unreliable revenue streams.

#### Clarifies Adjustments to Earnings

QoE reports typically adjust earnings for non-recurring items (e.g., legal settlements, one-time costs), revenue recognition issues, and potential accounting anomalies. This provides a more realistic, normalized view of ongoing profitability, which is crucial for an acquirer assessing future earnings potential.

#### Prepares for Buyer Scrutiny

Buyers, especially in the financial services industry, will conduct their own QoE analysis as part of the due diligence process. By preparing a QoE report beforehand, the seller ensures alignment with how buyers typically assess the financial health of the institution, reducing the likelihood of disputes over financial data.

#### Supports Deal Structuring

A QoE finding may also help the seller, and their advisors structure the deal (e.g., identifying earn-outs or performance-based payments) based on sustainable earnings metrics. This could be particularly important in deals where future earnings projections significantly impact the sale price.

#### Key Areas Covered in a QoE Report for Banks and Credit Unions include:

- Core vs. Non-Core Earnings
- Credit Loss Provisions
- Interest Income & Margins
- Fee-Based Income
- Loan Portfolio Quality
- Operating Expenses
- Capital Expenditures and Investments
- Regulatory Compliance Costs

### Final Thoughts

The seller typically engages an external firm to perform the QoE analysis before officially marketing the institution to potential buyers. It's often part of the preparation phase alongside other key sale documents like the Confidential Information Memorandum (CIM). QoE should be coordinated with the institution's external auditors to ensure consistency in how financials are presented and to avoid any discrepancies between audited financial statements and the QoE report.

Overall, Quality of Earnings, or QoE, is a universal concept in M&A transactions that institutions should be aware of. Regardless of when a QoE is performed, a potential buyer will often require a QoE, so, it's important to anticipate the need for one when considering an M&A transaction.

# The Importance of Organized and Accurate Business Records in M&A Transactions

Mergers and acquisition (M&A) transactions represent pivotal moments for companies, marking significant shifts in strategy, market positioning, and organizational structure. The success of these transactions often hinges on a critical yet sometimes overlooked factor: the state of a company's business records. Organized and accurate business records are not merely administrative tools but fundamental components that underpin every aspect of the M&A process. Here's why maintaining meticulous business records is essential for successful M&A transactions.

### Facilitating Due Diligence

Due diligence is a comprehensive review conducted by the acquiring company to assess the value and risks associated with a target company. This process involves scrutinizing a wide range of business records, including financial statements, contracts, legal documents, and operational data. Accurate records are crucial for due diligence because they provide a clear, truthful representation of a company's operations and financial health. Disorganized or inaccurate records can obscure critical information, potentially leading to incorrect assessments, overvaluation, or missed risks. Ensuring that records are well-organized and precise helps facilitate a smoother due diligence process and supports a more informed decision-making process.

### Ensuring Valuation Accuracy

Determining the negotiated transaction value of a company is central to M&A negotiations. Transaction valuation typically relies heavily on both reported financial results and normalizing adjustments, as well as other business agreements. Inaccurate or incomplete records can lead to flawed valuations, which may skew the negotiation terms and result in financial losses or disputes. Well-maintained records ensure that valuations reflect the true state of the business, thereby providing a solid foundation for fair negotiations and reducing the risk of financial discrepancies post-transaction.

**Compliance and Regulatory Assurance:** M&A transactions are governed by various regulatory and compliance requirements, including financial reporting standards, antitrust laws, and tax regulations. Accurate and organized business records are essential for meeting these legal obligations. They provide necessary documentation for regulatory filings and help ensure adherence to legal requirements. Disorganized records can lead to compliance issues, regulatory penalties, or delays in the transaction process, all of which can jeopardize the success of the deal and incur additional costs.

### Mitigating Risks

Effective risk management is vital during an M&A transaction. Business records play a key role in identifying and evaluating potential risks such as off-balance sheet liabilities, unresolved legal issues, or operational inefficiencies. By thoroughly reviewing organized records, both buyers and sellers can uncover potential risks and address them proactively. This helps mitigate unforeseen problems arising after the transaction, which could lead to post-closing disputes, as well as significant financial and operational challenges.

### Strengthening Negotiation Position

During M&A negotiations, having access to accurate and organized business records can provide a significant advantage. For buyers, detailed and well-maintained records offer insights that can be used to negotiate more effectively, identify areas for cost savings, and spot opportunities for value creation. For sellers, presenting organized records demonstrates transparency and can be leveraged to negotiate better terms and secure a higher valuation. This transparency fosters trust between parties and can lead to more favorable deal conditions.

### Streamlining Integration Planning

Post-transaction integration is a critical phase where the success of the M&A transaction is largely determined. Accurate business records are crucial for effective integration planning. They provide detailed information on the company's operations, systems, and processes, which is necessary for aligning and merging the operations of the acquiring and target companies. Disorganized

records can create obstacles in developing realistic integration plans, potentially leading to disruptions in business operations, inefficiencies, and failure to realize anticipated synergies.

### Preventing Post-Transaction Disputes

Discrepancies in business records can lead to disputes between buyers and sellers even after the deal is closed. Accurate and well-organized records help prevent such issues by providing a clear and agreed-upon financial and operational baseline. This clarity reduces the likelihood of conflicts over performance metrics, financial obligations, or compliance issues, and helps maintain a positive relationship between the parties involved.

### Conclusion

In the world of M&A, organized and accurate business records are far more than a matter of administrative convenience. They are critical to the integrity and success of the entire transaction process. From facilitating thorough due diligence and ensuring accurate valuations to meeting regulatory requirements and managing risks, well-maintained business records underpin every key aspect of M&A transactions. They also play a crucial role in strengthening negotiation positions, streamlining integration, building confidence, and preventing post-transaction disputes. For companies engaged in M&A activities, investing in the organization and accuracy of business records is not just a best practice, but a fundamental requirement for achieving successful and smooth transactions.

# 02

# Tax Planning for M&A




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## Why M&A Tax Planning is Even More Important in Today's Regional Banking Environment

Unrealized losses on securities, increased vacancies in CRE, and the flight of yield seeking depositors have created a challenging situation for regional banks. In this environment, banks may seek to engage in M&A transactions to improve efficiency and competitiveness. Additionally, the recent enactment of HR 1, also known as the Big Beautiful Bill, may create business opportunities that should be considered both by Acquiring and Target Banks. This executive summary and the following sections will address some key issues for Banks to consider in today's environment.

### Tax Due Diligence

Whether you are an Acquirer seeking to evaluate a Target Bank, or a Seller looking to get your ducks in a row to prepare for a deal, today's environment also raises new challenges for tax due diligence. Where does Target operate? Will a merger of Target Bank into Acquiring Bank trigger state tax nexus in any new states for Acquiring Bank? Do any of those new states require combined or unitary income tax returns? Does Acquiring Bank already have customers in states where Target Bank operates, but Acquiring Bank has not yet filed state tax returns in those states? Has Target implemented aggressive state tax planning strategies? See key Seller and Buyer considerations in the following sections.

### Executive Compensation

Enacted tax law changes will, in future tax years, restrict or eliminate the deductibility of executive compensation, even in situations where the Target executive continues with Acquiring and would not otherwise have been a covered employee under the rules. This "once covered, always covered" rule can also reduce or eliminate the future value of existing DTAs at the Target.



Target executives may also have golden parachute arrangements, which may result in large change of control payments becoming not deductible. Prudent tax planning in advance of an M&A transaction can reduce or, in some cases, eliminate the nondeductible nature of these payments, while in many cases leaving the Target executive in no worse a position, or even possibly in a better position, on their personal income tax returns.

See the following sections for more information.

### Optimizing State Tax Structure

It is rare that a Target Bank Holding Company, Bank, and Non-Bank Subsidiaries will fit seamlessly in the Acquiring Bank organization chart. For one thing, Target may operate in states where the Acquirer may have customers but is not presently filing. As another example, Target Bank may be primarily subject to state net worth taxes while Acquiring Bank pays only state income tax. To make it even more interesting, Target may have special purpose entities, such as a REIT or a Passive Investment Company, which are new to Acquiring Bank.

The good news is that the M&A deal is usually a non-tax motivated transaction with both economic substance and significant non-tax business purpose that creates the opportunity to optimize the post transaction state tax posture.

### Regulatory Capital

All Regional Bank CEOs and Boards have had to become extremely familiar with the rapidly evolving Bank Regulatory Capital Rules, and the further potential changes being discussed today. And an M&A transaction may be beneficial to the Acquiring Bank if it is expected to result in increased CET1 capital in the future.

However, a proposed M&A deal may have income tax consequences that reduce regulatory capital. Accordingly, it is important for an Acquiring Bank to understand the tax impacts of the transaction up front in order to avoid any unintended surprises. The following sections will discuss the circumstances in which regulatory capital can be impacted by tax rules.

### Conclusion

The following sections will address these issues individually in more detail. We would be glad to discuss these and other bank tax M&A issues with you at your convenience.

# Selling Bank: Getting Your Ducks in A Row

In order to make the M&A transaction process move as efficiently as possible, a Selling Bank will need to accumulate information for the Buyer Due Diligence Team, typically in an on-line data room. While not all inclusive, following is a list of the Top Ten tax due diligence disclosures that a Buyer will want to see.

1. Tax returns for all years open under the federal and state statutes of limitations, for both the Selling Bank and any institutions that Selling Bank has acquired in stock purchases or whole bank acquisitions.
2. For any prior transactions, a description of the transaction, including whether it was treated as a stock purchase, tax-free reorganization, or asset purchase for income tax purposes, including description of any related elections, and a summary of the consideration paid (cash, stock, etc.).
3. Copy of any recent IRS or state tax concluded tax examinations reflecting any adjustments. For ongoing examinations, list of any material proposed adjustments. Include sales and other non-income taxes.
4. Detail listing of cumulative book-tax temporary differences, and the federal and state deferred tax rates applied to calculate gross deferred tax assets and liabilities, reconciled to the most recent financial statement tax footnote. For significant amounts that do not come directly from a General Ledger account balance, such as fixed asset tax basis or partnership tax basis, the underlying support should be referenced and available. Also provide support for any valuation allowances, or the lack thereof, against NOL or tax credit carryforwards.
5. Analysis of Goodwill, including: (a) the amount created by tax free reorganization or stock deal purchase accounting, which is not deductible for income tax return purposes, and (b) the amount created by taxable branch or other asset purchases that is deductible over 15 years for income tax purposes.
6. Organization chart showing the Holding Company, Bank, and any Non-Bank Subsidiaries, including description of any special purpose entities, such as REITs, Passive Investment Companies, Insurance Companies, etc. For each entity the chart should reflect whether it is included in the federal consolidated return and whether it files individual or combined/consolidated state income tax returns.
7. Copy of any IRS rulings received, Tax Accounting Method Changes filed, and tax opinions received on any material tax planning transactions. This should also include any tax shelter disclosures or reflect that Selling Bank has not engaged in any known listed transactions or transactions of interest (for example, did the Selling Bank claim the Employee Retention Tax Credit (ERTC), etc.). Also include the details supporting ASC 740 uncertain tax position financial statement disclosures.
8. For significant tax accounting methods, such as bad debts, tax credit investments, loan fees and costs, a description of the basis for calculating any book tax differences (for example, bad debt conformity elections, proportional amortization for tax credits, etc.).
9. If BOLI is significant, a listing of the type of policy (general account or separate account), the original amounts invested, and whether any covered individuals are not still employed by the company.
10. Copies of any Change of Control Agreements, Deferred Compensation Agreements, and a description of how the $1m compensation limit is allocated among cash and non-cash compensation. Also copies of any Investment Banker and Legal Engagement Letters and a description of the intended treatment of transaction costs.



# Acquiring Bank: Considerations

As the Acquiring Bank, the Due Diligence team will have a limited amount of time and will need to focus on material exposures and planning opportunities that impact deal value. While not all inclusive, the following is a list of the Top Ten issues to consider during tax due diligence.

1. Is the Selling Bank filing combined, consolidated or unitary returns in all states where such filings are required? Does the Selling Bank have any employees or customers located in states in which it is not filing tax returns? Is the Selling Bank operating in any state that will be new to Acquiring Bank? Consider the impact of post-merger apportionment on Acquiring Bank's deferred tax balances, since any adjustment to those balances, including those recorded in OCI, will result in income tax expense from continuing operations.
2. Has the Selling Bank implemented any "aggressive" tax planning strategies or structures? If so, has the Bank recorded any ASC 740 reserves? Have any of these strategies or structures been challenged by federal or state tax authorities? Have all reportable transactions and transactions of interest been disclosed on federal and state income tax returns? Did the Bank get any rulings or tax opinions related to such transactions, and are they available for review? Has the Bank claimed ERTC?
3. Are there any unrecorded book – tax differences related to prior acquisitions? For example, if a wealth management or insurance agency subsidiary was acquired in a stock for stock type "B" reorganization for income tax purposes and the acquired entity is still a subsidiary. Is there an unrecorded deferred tax liability related to BOLI because the Bank intends to hold the policy until death of the insured? Does Selling Bank have tax deductible goodwill from prior branch purchases – consider that Acquiring Bank, once it eliminates Target Bank book goodwill in purchase accounting, may not be able to record a deferred tax asset for Target Bank tax deductible goodwill.
4. Are cumulative book/tax differences that do not arise from a general ledger account balance regularly reconciled to underlying support (for example, partnership tax basis)? Is that support available for us to review? When new General Ledger accounts are opened, is a tax department person involved? If book accrual balances are restructured during the year, is the tax department aware and involved so that they can determine the impact on the tax return? Has the Target Bank properly evaluated whether valuation allowances should be recorded against federal or state tax NOL or credit carryforwards? How will the proposed transaction impact those carryforwards and the need for valuation allowances?
5. Are there any "golden parachute" change of control agreements? If so, are payments capped so as not to trigger a §280G excise tax? Is the Bank responsible for any "gross up" payments? Are there any deferred tax assets recorded for deferred compensation that may not be deductible under the $1m limitation? How has the Bank allocated the $1m limitation between cash and non-cash compensation? Has the Bank considered the impact of the "once covered always covered" rule for executives of banks that have been acquired in the past? Has the bank modified any deferred compensation agreements that may be subject to §409A? Will Target Bank's pension plan be merged into the Acquiring bank's plan, or will it be terminated? Is it in an overfunded or underfunded position? If an overfunded plan is to be terminated, how can potential non-deductible excise tax implications be mitigated?
6. For tax credit investments, is the Bank using proportional amortization for any tax credit investments? Do any tax credit investments involve a lease structure? Did the sponsor provide an income tax opinion with regard to the investment, and does that opinion indicate that the investment meets IRS safe harbors? Describe any sponsor or insurance guarantees.

7. Has the Bank utilized the Bad Debt Conformity Method or Industry Directive to support the deduction of Bad Debts? If yes, when was the method first applied, and have all procedural requirements been met? If not, is the Bank simply deducting book net charge offs on its federal income tax return?
8. If the Target Bank has BOLI, is it general account or separate account? Are all covered individuals still employees of the Bank? Have all employee notice requirements been met, and tax return disclosures filed? Has the Target Bank acquired any BOLI in prior bank M&A deals? If yes, describe the nature of the merger transaction.
9. Have there been any material federal or state income tax adjustments on recent audits? Are there any significant proposed adjustments or unresolved issues on current exams? Has the Target Bank filed for any voluntary disclosure agreements to mitigate state tax nexus exposure? Is the Target Bank following state tax statutes and regulations in calculating apportionment? For any dissolved entities, have final returns been filed and Secretary of State clearance obtained for the entity?
10. Were Target Bank prior M&A transactions properly characterized for income tax purposes, and were all necessary elections timely filed? Did Target properly elect the IRS safe harbor for success-based fees, and does it intend to make the same election on the proposed transaction?



# Executive Compensation

Often one of the first issues to be addressed in the early stages of M&A deal discussions is that of Executive Compensation for the Target Bank CEO and other senior executives. The following overview highlights certain of the key issues.

## §162(m) $1 million Dollar Compensation Limitation

The Tax Cuts and Jobs Act (TCJA) of 2017 removed the prior exception to the $1m limitation for performance-based compensation and expanded the number of executives covered. A further expansion is scheduled to become effective in 2027. Further complicating the scenario, options may be exercised, triggering tax events, or deferred compensation may be paid out years into the future.

One key area for the Acquiring Bank to understand is how the Target Bank allocates the $1m compensation limitation between current cash compensation and options or deferred compensation to be triggered in the future. If the Target Bank allocates the full $1m limitation to current year cash compensation, there may be no tax deductions in the future for the exercise of stock options. Also, whether deferred compensation paid out in the future will be deductible may depend on the timing of when the executive chooses to retire and over what period the deferred compensation Is paid out.

Finally, if Target Bank executives are covered individuals for purposes of the $1m compensation limitation, they will always be covered individuals when employed by the Acquiring Bank in the future. And the enacted expansion of §162(m) which becomes effective in 2027 will bring additional executives into the definition of covered individuals.

An Acquiring Bank will need to evaluate whether deferred tax assets recorded will actually result in tax deductions in the future, and not be limited.

## §280G Golden Parachute Limitation

Generally speaking, if an individual has a change of control payment that exceeds three times the base period compensation, the excess of the total amount of the change of control payment over ONE times base period compensation will be non-deductible to the payor and the individual will be subject to a non-deductible excise tax. While less common recently, historical change of control agreements often required the paying Company to "gross up" the executive for the cost of the excise tax. Thus, exceeding the §280G limitation by even $1 could trigger the disallowance of significant deductions and the imposition of large non-deductible excise tax.

However, there may be opportunities to reduce or eliminate the impact of §280G. In certain situations where an executive is responsible for the excise tax, reducing the amount of the change of control payment so that it does not exceed three times base period compensation, thus eliminating any excise tax, may result in the executive netting more cash benefit from the reduced payment, as well as making the reduced payment deductible to the payor. There also may be opportunities to pay the Target executive through non-compete agreements (assuming challenges to the new FTC rules are ultimately upheld), or through post transaction employment for services rendered. Careful consideration must be given to comply with the tax rules in this area.

# Optimizing State Tax Structure

The Acquiring Bank and Target Bank groups will likely have different structures, operate in different states, and be involved in different lines of business. The following are the Top Ten issues to consider in optimizing the post transaction state tax posture rules in this area.

1. Does the Target operate in states where it is subject to Net Worth or non-income-based taxes (for example. PA or Ohio)? If yes, does Target Bank or Acquiring Bank have non-bank subsidiaries that are paying income tax in those states? If so, such subsidiaries could be merged into the Bank, eliminating the state income tax with perhaps no significant impact on the Net Worth Tax.
2. Does either the Target Bank or the Acquiror have a special purpose entity (e.g., a Connecticut Passive Income Company, or PIC)? How does the transaction impact qualification of the special purpose entity – for example, will key employees familiar with the company be retained?
3. Will the transaction cause Acquiring Bank to file in new states, or to file combined, consolidated or unitary returns for the first time? If so, what is the impact on Acquiring Bank's state tax rate? Does Acquiring Bank have customers in states which it is not presently filing but Target Bank is filing in those states? Will the transaction result in exposure to Acquiring Bank for pre-transaction years? Does Acquiring Bank need to consider applying for a voluntary disclosure agreement in those states?
4. Are there opportunities to move operations between states or combine entities in connection with the transaction that may result in more favorable apportionment? Compare the tax apportionment rules in Target Bank's significant states vs the corresponding rules in Acquiring Bank's key states. If employees need to relocate, consider the cost of any assistance that may be required.
5. Is the Target taking advantage of all state and local tax credits and incentives for which they are eligible? For example, new employee credits, investment tax credits, low-income housing or rehab tax credits, favorable tax zones, etc.? Some of these tax incentives may have deadlines for applications. Are there any state incentives for maintaining the current level of employment after the transaction?
6. Are there opportunities to file amended returns to take advantage of more favorable apportionment or claim tax credit incentives that do not require an application?
7. Can Target Bank's organizational structure be simplified by combining or merging entities in order to reduce the number of filings?
8. Does Target Bank have any state tax net operating losses or credit carryforwards? If yes, how will the transaction impact those carryforwards, including any limitations? Is there an opportunity for Target Bank to sell assets prior to the transaction to fully utilize any carryforward attributes? Are there entities for which it makes sense to have the Target subsidiary survive a merger with the corresponding Acquiring subsidiary in order to preserve favorable tax attributes?
9. Does Target have entities which are statutorily excluded from filing in the Bank combined consolidated or unitary return? Is there any advantage to maintaining that entity after the transaction?
10. Many states have different filing requirements for bank or securities broker dealer entities and/or special apportionment. Has the Target Bank been filing the appropriate returns for Bank and non-bank entities and using the proper apportionment regime? If not, there may be either exposures or opportunities for filing amended returns.



# M&A Tax Impact on Regulatory Capital

The typical regional bank merger creates a short period federal income tax return. If the merger is timed too early in the calendar year, one-time costs, such as cashing out Target executive stock options, systems conversion, the sale of underwater debt securities, and safe-harbor investment banking fees may create a tax net operating loss (NOL). NOLs may no longer be carried back but have an indefinite carryforward subject to annual limitations.

However, for regulatory capital purposes, the deferred tax asset (DTA) created by tax NOLs goes into the "bad DTA bucket" and, after netting any allocated deferred tax liabilities (DTLs), gets fully disallowed for purposes of regulatory capital. The same goes for any DTAs arising from capital loss or tax credit carryforwards. While many transactions are put on hold pending regulatory approval, once that approval is obtained, it may be prudent to consider timing the closing date of the transaction so as to avoid too short of a final tax year return period in an effort to limit, or even avoid, incurring NOL's or other tax attribute carryforwards.

Besides the federal tax issues, regulatory capital may also be impacted by state tax consequences of an M&A deal. For example, Target Bank or its Subsidiaries may have significant state tax NOL or other credit carryforward amounts, but, depending on the nature of the M&A transaction, and the specific state rules, those carryforwards may not survive the merger or may be significantly limited.

To mitigate these potential federal and state adverse tax impacts on regulatory capital, the Acquiring Bank should obtain the right to review, once the transaction has closed, a draft of Target's final short period federal and state income tax returns, in order to take any actions that might avoid or reduce a tax NOL or other carryforwards in that short period. This could include electing out of bonus depreciation (to the extent otherwise allowable) or electing to capitalize certain expenses. In some cases, particularly with non-Bank subsidiaries, it may be critical that Target's entity survives any post transaction mergers or consolidations.

Target Banks who wish to be more attractive to Acquiring Banks can also take independent actions during the final short tax period to reduce or eliminate a tax NOL or other carryforwards.

# 03

# Valuation Considerations for Financial Institutions


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Fair value is a critical concept in financial reporting, particularly for intangible assets in acquisition accounting, impairment testing, and other GAAP-related reporting requirements. Acquisitions require the allocation of purchase price to various intangible assets, and post-acquisition, these assets are subject to periodic fair value testing for potential impairment.

## Asset Categories:

- Bank assets can be classified as either tangible or intangible, with financial and general intangible assets forming a significant part of the institution's value.
- Goodwill often represents a substantial component of intangible value, captured when it cannot be specifically allocated to other intangibles.

## Intangible Assets:

- Financial institutions possess several intangible assets that hold significant value, such as core depositor relationships, mortgage and loan servicing rights, and customer relationships in credit cards and leasing.
- Other important intangibles include regulatory approvals, specialized software, and a trained workforce.

## Types of Intangible Assets

### 1. Customer Relationships:

- **Existing Client Base:** The value of established relationships with individual, commercial, and institutional clients, including depositors, borrowers, and investment customers.
- **Loyalty & Retention:** The likelihood that these customers will remain with the institution post-acquisition and continue to generate revenue.

### 2. Core Deposit Intangibles (CDIs)

- **Low-Cost Funding Source:** The value associated with the institution's core deposits (checking and savings accounts) that provide stable and inexpensive funding relative to market borrowing rates.
- **Customer Stickiness:** These accounts often have low turnover rates and are difficult for competitors to capture, making them a highly valuable intangible asset.

### 3. Brand Value

- **Reputation and Recognition:** The value of the institution's brand name, market presence, and trustworthiness, which can attract new customers and retain existing ones.
- **Market Perception:** A strong brand can command a premium and help with customer acquisition, partnerships, and overall business growth.

### 4. Proprietary Technology

- **Banking Software & Platforms:** Value in proprietary systems used for customer interaction, banking operations, or risk management that may provide a competitive advantage.
- **Digital and Mobile Banking Capabilities:** Enhanced digital infrastructure that facilitates online banking, mobile applications, and user-friendly customer service platforms can be a significant asset.

### 5. Trade Secrets and Proprietary Processes

- **Risk Management Models:** Unique or proprietary methods for assessing credit risk, pricing loans, or managing investment portfolios.
- **Lending and Underwriting Algorithms:** Proprietary algorithms or models that streamline loan approvals and improve credit decision-making processes.

### 6. Non-Compete Agreements

- **Restrictive Covenants:** Agreements that prevent key executives or employees of the acquired institution from starting or joining a competing financial institution, which helps protect the buyer's competitive position.

### 7. Trademarks and Licensing

- **Institutional Logos and Names:** The rights to use trademarks, trade names, and any recognizable logos associated with the institution, which may be critical for maintaining brand identity and customer trust.
- **Licensing Agreements:** Rights to use specific financial products, software, or other proprietary intellectual property that the institution has licensed or developed.

### 8. Loan Servicing Rights

- **Servicing Fee Income:** The right to earn fees by managing and servicing loans that the financial institution originated or acquired. This includes mortgages and commercial loans where the bank collects payments, manages accounts, and handles customer service.

### 9. Regulatory Licenses and Approvals

- **Banking Licenses:** Licenses that allow the institution to operate in specific jurisdictions, particularly in highly regulated markets, which may hold significant value due to the difficulty and time required to obtain them.
- **Special Regulatory Privileges:** Certain institutions may have valuable relationships with regulators or special authorizations, such as broker-dealer licenses or foreign exchange trading approvals.

### 10. Goodwill

- **Excess of Purchase Price Over Fair Value of Assets:** Goodwill represents the premium paid above the fair value of net identifiable assets and liabilities. It reflects the buyer's expectation of future synergies, growth, and overall profitability that result from the acquisition.

# 04

## Connect With Us

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# Strategies for Success in Today's M&A Landscape

**Jamie Card, Partner & Financial Services Industry Leader, and Jeff Cardone, Partner, Luse Gorman, recently hosted a webinar to discuss the trends and hot topics in M&A. The following slides outlines their discussion.**

## Presenters

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2

## Agenda

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**Discussion of Current Trends & Hot Topics Surrounding the M&A Landscape**

- General overview of the M&A environment
  - Credit unions
  - Investor groups
  - Trends with mutuals
  - Banking subsidiaries
- Other M&A considerations

3

# M&A Environment

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## M&A Environment - General

- Lowest activity since 2009 financial crisis
- Why Decreased Activity?
  - Lower stock prices limited buyers' ability to utilize their currency
  - AOCI
  - Loan interest rate marks
  - Turmoil in early 2023 - bank failures and liquidity crisis
  - Uncertainty – inflation, interest rates, credit quality
- **What are we seeing?.....**

5

## Credit Unions Buying Banks

- Represents about 20% of all bank M&A transactions during 2024 (pace of CU/bank deals the same, but overall bank M&A down)
- Mostly in Midwest and Southeast
- First Announced Deal in New York – Hudson Valley CU/Catskill Hudson Bank
- Why credit unions want to acquire banks?
- Why are credit union buyers are in the mix?

6

## Non-Traditional Buyers – Credit Unions

- **Typical Issues:**
  - Greater Execution Risk – Over 15% of bank deals with CU buyers since 2011 terminated, 3.8% for traditional bank deals.
  - Longer regulatory approval process (more regulatory scrutiny of these transactions).
  - State authority, processing and policy concerns.
  - Converted thrift liquidation account.
  - Structural pricing and dissolution issues.

7

## Non-Traditional Buyers - Investor Groups

- Playing largest role in bank M&A in over a decade
- Represents almost 10% of all transactions
- Why?

8

## Non-traditional Buyers - Investor Groups

- Additional Diligence
- Merger Agreement Provisions
- Among 10 terminations in 2023, 4 were “investor group” transactions

9

## MOEs and Mutual-to-Mutual Acquisitions

- For Mutual-to-Mutual Acquisitions, added benefit of ability to keep banks separate.
- Why Is This Currently Attractive?

10

## MOEs and Mutual-to-Mutual Acquisitions

- General Observations and Issues:
  - Much longer developmental period because heavier reliance on social issues (never truly a merger of equals).
  - Greater focus on C-Suite succession, Board succession, maybe as granular as board committee designations.
  - Greater focus on pro-forma budget and collective cost saves and preferred vendors.
  - Most of “integration” and “post-closing governance” discussions should be addressed pre-execution rather than post-execution.

11

## Banking Subsidiaries

- Insurance companies
  - Banks are actively exiting this market
- Wealth management
  - Banks are seeking opportunities to expand into this market

12

# OTHER M&A CONSIDERATIONS

13

## Developing Interested Parties and Pricing Terms

- How to Develop Interested Parties
  - Long Term Relationships
  - Close vs. wide auction process
- Important to carefully negotiate/craft Letter of Intent (LOI)
- Pricing Terms and Interest Environment:
  - Consideration/treatment of AOCI
  - Interest rate movements/purchase accounting marks can impact pricing/pricing mechanisms
  - Goodwill

14

## Diligence – Important it is Comprehensive

- Cannot disclose confidential supervisory information
- Need to qualify deal costs
- Need to identify all required third-party consents

- Diligence very comprehensive, specifically:
  - (1) investment portfolio;
  - (2) lending portfolio;
  - (3) key people, agreements, restrictive covenants; and
  - (4) shareholder base

15

## The Importance of Engaging Specialists

- Engage early in the process
- Ensure open dialogue amongst key advisors
- Failure to do so could result in the negative ramifications of decisions made throughout the process that cannot be unwound

16

## Regulatory Meetings – Better Ensure Approvals/Regulatory Relations

- Must be with appropriate agency “decision-makers”
- Provide summary business plan (with basic pro formas) of resulting institution
- Identify: (1) any new product lines or services or (2) larger than usual growth expectations
  - Especially important in investor transactions
- Address issues/unique aspects of a transaction.

17



## What Creates Deal Uncertainty and Delays?

- Regulatory Processing Issues
- Compensation Structuring Issues
- Non-traditional Buyers (Credit Unions, Investor, Fintech)
- Large Fair Value Marks
- Unexpected or larger than expected movements in the market

18

## New DOJ Merger Guidelines

May Result in More DOJ Involvement:

- Significantly lowering the standards by which the DOJ presumes a merger is substantially likely to lessen competition
- A merger that creates a combined share over 30% presents an “impermissible threat of undue concentration” if HHI increases of 100 points

19

# OCC Policy Statement on Bank Merger Act

- OCC adopted a proposed policy statement to provide transparency on how OCC reviews merger applications
- Policy provides merger applications that are consistent with approval feature ALL the following indicators:
  - Acquirer is well capitalized and resulting institution will be well capitalized
  - Resulting institution is less than $50B in assets
  - Acquirer CRA rating of Outstanding or Satisfactory
  - CAMELS/Consumer rating of 1 or 2
  - No fair lending/BSA/AML/consumer compliance issues
  - Target's assets are less than or equal to 50% of acquirer's total assets
  - Transaction does not have significant adverse effect on competition
- Policy provides the following indicators will likely lead to non-approval unless resolved:
- Acquirer has a CRA rating of Needs to Improve or Substantial Noncompliance
- CAMELs/Consumer rating of 3 or worse
- Acquirer has pending BSA/AML/fair lending action

20

# Critical Elements of Formal M&A Strategy

- Holistic review of strategic plan, incorporating M&A into such strategy
- Keep board engaged; review M&A activity in your marketplace
- Keep regulatory house in order

21

# Human Capital Considerations – M&A/Potential Pitfalls

- Before the transaction (way before) the "target" institution will want to make sure its compensation arrangements are in order
- Do executives understand the terms of the agreements and the payments that will be made under them?
- Are there expectations that are not in writing?
- Are there changes that need to be made to the arrangements?
- Be aware of change in control definitions (both institutions may have triggering definitions)

22

# Compensation is Governance (and not solely an HR Function)

- New or Revised Arrangements
  - Compensation Adjustments
  - New Officer Positions
  - Employment Agreements
  - Change in Control Agreements
  - Non-Qualified Retirement Plans (or enhancements)
  - Consulting Agreements
  - Non-Compete and Non-Solicit Agreements
  - Retention Plans/Stay Bonuses
  - Advisory Boards

23

05

# Business Combination Accounting M&A Implications


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## We Acquired a Business… Now What?

Under Accounting Standards Codification ("ASC") 805, Business Combinations, a business combination occurs when an entity obtains control of a business by acquiring its net assets, or some or all of its equity interests. It may sound pretty straightforward, but in reality, the closing of a deal is just the beginning of the journey.

Under ASC 805, once control of a business is obtained, the acquirer recognizes the assets acquired and liabilities assumed at 100% of their fair value on the acquisition date even if less than 100% of the equity interests are acquired. Business combinations involving financial institutions have many industry-specific complexities to take into consideration. Prior to even getting into the debits and credits of recording the acquisition, however, management should be asking the following questions:

### Does the transaction constitute an acquisition of a business or an asset acquisition?

Prior to assessing whether a business combination has occurred, ASC 805 states that the entity being evaluated must meet the definition of a business. Under US GAAP, an initial screening test is required to assist in the determination. If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset, then the acquisition should in fact be accounted for as an asset acquisition as opposed to a business combination, which results in significantly different accounting. However, if that screen test is not met, then further analysis is needed to determine if the acquired set of assets and activities meets the definition of a business because it consists of inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs.

While this test may seem simple, it is important to remember that you may be required to follow business combination accounting even in instances where an entire business is not acquired. Business combination accounting rules may apply to transactions that are not a full acquisition of another company, including branch acquisitions, purchase and assumption agreements, etc. In most instances, we feel a branch acquisition will trigger business combination accounting, whereby acquiring a loan portfolio may not. It is encouraged to discuss potential accounting implications of any type of acquisition with your external accountants and regulators to ensure proper treatment is followed.

### If deemed a business combination, which entity in the business combination is the accounting acquirer?

ASC 805 indicates that for each business combination, one of the combining entities is to be identified as the acquirer for accounting purposes. The process of identifying the acquirer begins with the determination of the party that obtains control based on guidance in the consolidation standards in ASC 810. According to ASC 810, Consolidation, the general rule is that the party that holds directly or indirectly greater than 50% of the voting shares of the combined entity has control. This analysis may seem relatively straightforward, and a lot of times it is. However, determining the accounting acquirer can be difficult when the combining entities are of nearly equal value or the shareholders of one entity do not clearly control the combined entity based on voting interests. In these circumstances, judgment will be required.

### What is the acquisition date for purposes of applying ASC Topic 805?

According to ASC 805, the acquisition date is the date on which the acquirer obtains control of the acquiree. This generally coincides with the closing date when assets are received and other assets are given, liabilities are assumed, or equity interest are issued. However, if control of the acquiree transfers to the acquirer through a written agreement, the acquisition date could be before or after the closing date.

### What is the nature and amount of consideration paid?

The consideration transferred in a business combination is measured at fair value and represents the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree, and the equity interests issued by the acquirer. Certain exceptions apply for any portion of the acquirer's share-based payment awards exchanged for awards held by the acquiree's employees. Examples of potential forms of consideration include cash, other assets, a business/subsidiary of the acquirer, contingent consideration, common or preferred shares, options, warrants or member interests. Careful analysis is needed for payments to former owners who enter into continuing employment relationships with the acquirer post-acquisition to determine if the payments represent consideration transferred or compensation expense. In addition, transaction expenses will need to be evaluated to ensure whether they can be included in consideration transferred or expensed as incurred.

## What is the fair value of the assets acquired and liabilities assumed?

The acquirer generally records tangible assets and liabilities assumed at their acquisition-date fair values. This may require adjustments to historical recorded amounts based on specific account analysis or valuations to be performed under ASC 820. In addition, there are certain exceptions to this fair value recognition principle, including assets and liabilities arising from contingencies, income taxes, employee benefits, indemnification assets, leases and contract assets and contract liabilities.

ASC 805 also requires acquired identifiable intangible assets to be recognized separately from goodwill if the subject intangible asset is either contractual or separable. Intangible assets are assets, other than financial instruments, that lack physical substance. Assets like trademarks, tradenames, customer lists, and patented technology are all examples of potential intangible assets. Specifically for financial institutions, core deposit intangibles, distribution channels, mortgage servicing rights and trust department relationships are additional items that may need to be recognized as intangible assets. Identifiable intangible assets could include both indefinite-lived and definite-lived intangible assets. Useful lives of definite-lived intangible assets will then need to be determined based on the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity. Given the potential complexity involved, third party valuation specialists might be required to perform valuations specific to the intangible assets identified.

US GAAP includes an accounting alternative (the "intangible assets accounting alternative") that allows a private company or not-for-profits ("NFPs") to limit the customer-related intangibles it recognizes in a business combination or acquisition by an NFP to those that are capable of being sold or licensed independently from the other assets of the business. The application of this accounting alternative, however, is limited to those entities that also adopt the goodwill accounting alternative described below.

## What is the resulting amount of goodwill to record in the transaction?

Goodwill is measured as the residual value remaining after the subtracting the net tangible and intangible assets acquired from the fair value of the entity. This requires an assessment of the fair value of the consideration transferred plus the fair value of any remaining noncontrolling interest. The measurement occurs on the acquisition-date and, other than qualifying measurement period adjustments, no adjustments are made to goodwill recognized as of the acquisition date until and unless it becomes impaired. To the extent the fair value of the net assets acquired in a business combination exceeds the amount of the consideration transferred (a "bargain purchase"), further assessment and analysis would be required as these situations are expected to be rare.

Under US GAAP, if a private company/NFP entity elects the accounting alternative to amortize goodwill ("goodwill alternative"), the entity may amortize goodwill on a straight-line basis over ten years, or less than ten years if the company demonstrates that another useful life is more appropriate. Otherwise, subsequent accounting including impairment considerations would need to be considered under the provisions of ASC 350.

## What are common items involved in business combinations that financial institutions should consider?

The items included in an acquisition involving banks generally consist of investments, loans, and deposits. To a lesser extent, accrued interest receivable/payable are also generally included.

Regardless of whether the investments held by the acquiree bank are classified as available-for-sale or held-to-maturity, both would need to be revalued to their respective fair values at the acquisition date. The acquiring company would then need to designate whether the investments retain their historical classification or not and account for them under the respective accounting rules depending on that selection.



Determining the fair value of loans is one of the most complex undertakings under purchase accounting rules. The fair value is typically determined utilizing a discounted cash flow approach. Determining the correct discount rates, prepayment speeds, defaults and loss severity requires complex modeling and significant judgment. Additionally, there is no carryover of the allowance for credit losses in a business combination. Instead, companies are required at acquisition to determine whether acquired loans have experienced a "more than insignificant" credit deterioration. Based on this analysis, loans (and other acquired financial assets) are determined to be either purchase-credit deteriorated assets ("PCDs") or non-purchased credit deteriorated assets ("Non-PCDs"). PCDs and Non-PCDs require two different accounting outcomes.

The allowance for credit losses for PCD loans are recorded with an offset to the amortized cost basis on day one, with no income statement effect. Non-PCDs on the other hand require the acquiring company to record a day one charge to credit loss expense for the allowance for credit losses. These separate methods can have significant impacts on the bank's yields on a going-forward basis. The Financial Accounting Standards Board ("FASB") recently proposed an Accounting Standard Update ("ASU") to adjust this accounting on a going-forward basis. As of going to print, the FASB continues to deliberate the change.

Lastly, the fair value of deposits is dependent on whether they are time or non-time related. Demand deposits are generally considered to approximate their book value and are recorded at it, whereas time deposits require a calculation to determine their fair value. A bank will generally also record what is commonly referred to as a core deposit intangible relating to its deposits. A core deposit intangible represents the fact that an acquirer would generally be willing to pay a premium when acquiring core deposit accounts as they are less expensive than an acquirers' marginal cost of funds.

Given the complexity of business combinations, the considerations above are not all encompassing of the factors that should be evaluated to ensure proper accounting under the standards.

06

# The Role of Internal Audit in M&A


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During a financial institution merger or acquisition, the Internal Audit (IA) department plays a crucial role in ensuring that the process is conducted smoothly, risks are managed, and regulatory requirements are met. Here are key steps that Internal Audit should take during a bank merger or acquisition:

## Pre-Merger/Acquisition Planning

**Understand the Transaction:** Review the merger/acquisition strategy, objectives, and key details, including the financial, operational, and legal aspects.

**Risk Assessment:** Identify and assess risks associated with the merger/acquisition, such as operational, financial, regulatory, and reputational risks.

**Audit Planning:** Develop an audit plan tailored to the merger/acquisition. Prioritize areas with the highest risk and ensure alignment with the organization's overall risk management framework.

**Establish Communication Channels:** Set up clear communication channels with key stakeholders, including senior management, the board of directors, external auditors, and legal advisors.

## Due Diligence

**Assess Internal Controls:** Evaluate the target financial institution's internal control environment, focusing on key areas like fraud prevention, financial reporting, compliance, and IT systems.

**Compliance Review:** Ensure the financial institution complies with regulatory requirements, including anti-money laundering (AML) laws, Bank Secrecy Act (BSA), Lending, Deposit and other relevant regulations.

**IT Systems and Data Integrity:** Assess the target financial institution's IT systems, data management practices, and cybersecurity posture. Identify potential integration challenges and risks.

**Operational Review:** Examine the target financial institution's operations, including key processes, procedures, and business continuity plans, to identify any gaps or inefficiencies.

**Quality Review:** Review a sample of the financial institution's lending and deposit portfolio to ensure proper documentation has been obtained and that underwriting practices are strong in the lending area. Ensure all account types are included in the sample and expand if necessary.

**Prior Audit and Regulatory Exams:** Review previous Internal Audit, Compliance and Regulatory Examination reports for items requiring attention.

## Integration Planning

**Align Policies and Procedures:** Identify differences in policies and procedures between the merging entities and plan for harmonization. Ensure that the combined entity will have consistent and effective policies.

**Assess Culture and Governance:** Evaluate the organizational cultures of both banks and the potential impact on the merged entity. Review governance structures to ensure they will be effective post-merger.



**Review Key Contracts and Commitments:** Analyze key contracts, commitments, and third-party relationships to identify any risks or necessary renegotiations.

**Develop Integration Audit Plan:** Create a detailed audit plan for the integration phase, focusing on critical areas such as financial reporting, compliance, and operational integration.

## Execution and Monitoring

**Monitor the Integration Process:** Continuously monitor the progress of the integration, ensuring that key milestones are met and risks are managed effectively.

**Real-Time Auditing:** Conduct real-time audits of critical areas during the integration, such as IT system migration, financial consolidation, and policy harmonization.

**Issue Identification and Resolution:** Identify any emerging issues during the integration process and work with management to develop and implement corrective actions.

**Update Risk Assessment:** Regularly update the risk assessment based on ongoing monitoring and audit findings. Adjust the audit plan as necessary.

## Post-Merger/Acquisition Review

**Conduct a Post-Merger Audit:** Perform a comprehensive audit of the merged entity after the integration is complete. Focus on evaluating the effectiveness of the integration, the accuracy of financial reporting, compliance with regulatory requirements, and the adequacy of internal controls.

**Assess Achievement of Objectives:** Review whether the merger/acquisition objectives have been met, including financial synergies, operational efficiencies, and strategic goals.

**Evaluate Governance and Oversight:** Assess the effectiveness of governance structures and oversight mechanisms in the merged entity.

**Provide Feedback to Management:** Offer insights and recommendations to management and the board on lessons learned and areas for improvement in future mergers or acquisitions.

## Reporting and Follow-Up

**Prepare Reports:** Document and communicate audit findings, recommendations, and observations to senior management, the audit committee, and the board of directors.

**Follow-Up on Recommendations:** Ensure that management addresses audit recommendations in a timely manner. Follow up to confirm that corrective actions have been implemented effectively.

**Continuous Monitoring:** Establish ongoing monitoring procedures to ensure the merged entity remains compliant with regulations and that risks are managed effectively.

07

# People, Processes, and IT's Role in M&A


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## The Importance of Due Diligence in M&A Transactions

Due diligence is an integral part of any M&A transaction. During this phase of the transaction, the parties outline internal and external risk factors, mitigate various issues, and lay out their acquisition strategy.

Risk mitigation in M&A through due diligence is only feasible by following a detailed and structured checklist. This checklist must address multiple facets of a target company, including:

- Overall organizational structure
- Finance and accounting
- Operations
- Tax liabilities
- Market and sales
- Human resources
- Information technology and cybersecurity

In a world of ever-changing cybersecurity threats and risks, organizations of all sizes and levels of complexity are targets of cybercriminals. Failure to appropriately perform due diligence procedures in the IT and cybersecurity space can lead to a data breach, which can lead to:

- Significant fines
- Loss of consumer confidence and trust
- Delays in the completion of the transaction
- Purchase price reduction
- Future liabilities and lawsuits

In order to limit short-term and long-term costs associated with a breach, organizations need to ensure that they have a strong sense of what controls are currently in place to identify, isolate, and mitigate risk. During most M&A activities, organizations are looking to purchase intellectual property and data. This data is protected using the various IT and cyber-centric security controls.

If the data is important to the acquiring organization, then it is more than likely that it will be important to and sought after by cybercriminals.

Leveraging a savvy cybersecurity consulting firm can significantly reduce these risks. These firms can perform the appropriate level of IT due diligence, which would include the following:

- A review of physical and logical security access controls
- Third party / vendor management
- Review of policies and procedures
- Compliance requirement reviews
- Penetration testing procedures
- Incident response planning and training Security awareness procedures
- Disaster recovery

Furthermore, leveraging a virtual Chief Information Security Officer (vCISO) can also be a significant difference maker. A second set of eyes watching the organization and not only ensuring that the security controls operate as designed, but also leveraging their years of experience to potentially identify new and evolving risks, can further strengthen the security posture of the organization.

Due diligence in the M&A world has never been more complicated. Cybercriminals can breach networks and exfiltrate or encrypt sensitive data from anywhere in the world. That is why it has never been more important that M&A activities include cybersecurity due diligence procedures, performed by reputable and experienced IT and cybersecurity professionals.

# The Importance of People, Processes, and Technology in M&A Transactions

The merging of two financial Institutions is fraught with complexities, from financial statement due diligence, to ensuring that the right resources are in place before, during, and after the transaction. Legal and even environmental considerations also can be complex, time consuming, and resource intensive. One area that often gets overlooked is the technology component.

Tracing data through a complicated IT network can be difficult given the speed with which transactions can occur.

In order to facilitate a smooth transition of the IT environment, stakeholders must get a full population of:

- People
- Processes
- Technology

## Technology

Having a complete and accurate population of applications is critical to the integration of complicated systems. If you are the acquiring organization, you will want to know:

**Who manages the technology at the target institution?**

Acquirers will want to know if an external managed service provider is performing the IT oversight function or if internal fulltime resources are being leveraged.

**What hardware and software are being used at the target institution?**

Understanding the makeup of the IT environment will help the Acquirer determine whether it has the appropriate resources to provide oversight over the environment and/or the migration of data into its existing environment.

**Where is the technology stack located? Is it on premises or in the cloud?**

This will impact whether physical security protocols need to be addressed as part of the IT due diligence process.

## Processes

Having clear and sustainable IT processes in place to ensure the completeness, accuracy, and restricted access to the target institution's information is critical. Acquirers will want to know the following:

**Have audits been conducted against the security protocols at the target organization?**

Regular audits against the IT environment can give the Acquiring organization a sense of comfort that security protocols are in place and operating to the extent that they limit the risk of unauthorized access to data. The audits could include internal and external penetration testing, vulnerability, and sensitive data scans, SOC1 and SOC2 audits, and/or regulatory assessments such as PCI DSS or nationally recognized assessment against the NIST or ISO frameworks; these could enable the Acquirer to gain the aforementioned comfort level.

**Do comprehensive policies and procedures exist?**

Understanding the policies and procedures created by the target organization will give the Acquirer a better sense of the security protocols implemented by the organization. They can also potentially provide insight relative to gaps in necessary IT controls.

## People

**How does this compare to the Acquirer's environment?**

Understanding the current and the future state of the environment will help the Acquirer determine whether it has the right people in place to support the systems as well as any system migration. This will help drive IT staffing needs throughout the transaction lifecycle.

IT due diligence is vital for any transaction. Understanding the processes and technology stack will help the acquiring organization determine whether it has the right people resources to protect the environment before, during, and after the transaction is complete.

# 08

# Leadership Considerations

## Five Lessons in Mergers & Acquisitions: Strong Leadership, Culture, & More

**The Bonadio Group's, CEO, Bruce Zicari, shares his experiences related to M&A and Leadership.**

As businesses seek growth and expanded market reach, many turn to mergers and acquisitions, including accounting firms. At The Bonadio Group, we've successfully navigated more than 20 mergers in the last 27 years and learned valuable lessons from each one.

I recently joined The Upstream Leader Podcast and sat down with their host, Heath Alloway, to discuss what I learned about mergers and acquisitions. We chatted about leading successful mergers, fostering integration, and building team trust. For organizational leaders considering M&A activity or those looking to improve their M&A processes, I believe Heath and I touched on some invaluable insights in this discussion that may address some of your questions or pain points.

Here are five of my key M&A insights discussed in our conversation:

Mergers and acquisitions are an art, not a science—there's something to learn from each one. Although they're not a science, there has to be a process, including vetting merger candidates, speaking with their leadership, and conducting due diligence.

When considering a merger or acquisition, it's key for the cultures of the two organizations to be a good match. Leadership from each company should spend a lot of time getting to know each other and seeing if the organizations are a cultural fit. Sometimes, you may come to a crossroads and know that it isn't going to work, and that's okay.

The integration period is the most critical—anybody can finalize a deal. Still, you have to spend a lot of time with a merged firm and its leadership, interacting and hearing what's going well and what they're frustrated about. Several times, I've seen firms do a merger that falls apart at the integration stage. The merger doesn't stop after it's been announced; that's just the beginning. It typically takes two years to feel like the two organizations have entirely integrated.


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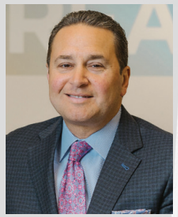

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You know a merger succeeds when you come together and improve each other. In our history of mergers and acquisitions, we've joined with firms with exceptional talent, leadership, and relationships in their market, which has made The Bonadio Group better. In turn, we have a wealth of resources and expertise, which makes the members of the new organization and their clients even better. It's all about finding a win-win situation for both organizations and making one plus one equal much more than two.

Historically, mergers and acquisitions have brought many fears and anxieties to the organization that is being merged or acquired. Over time, I've found that the best way to work through those fears and emotions is to sit down one-on-one with each new member of the merged organization and learn about their passions, interests, and what they're looking for in their new role. You have to spend a lot of time understanding what this change means for them to make it a positive experience for all.

To hear more M&A insights, please listen to the full podcast episode or read the transcript. Additionally, if you'd like to discuss your specific M&A situation or concerns, our experts are here to help contact us.

09

# Recent Developments

## The Justice Department's Shift to 2023 Merger Guidelines for Bank Mergers

The U.S. Department of Justice (DOJ) has announced its withdrawal from the 1995 Bank Merger Guidelines, affirming that the 2023 Merger Guidelines will now serve as its sole authority across all industries, including banking. In conjunction, the DOJ released commentary on the application of the 2023 Merger Guidelines to the banking sector, which addresses potential competition issues in bank mergers and outlines the relevant sections of the guidelines that inform the department's analysis. While the commentary provides insight into the DOJ's merger review process, it is important to note that it does not create new legal rights or obligations under current banking merger laws.

The decision to retire the 1995 guidelines, which was made with input from key banking regulators, the Federal Reserve, the FDIC, and the OCC, reflects a broader shift in the government's approach to bank merger oversight. Additionally, the FDIC and OCC both also announced changes to their procedures for reviewing bank merger applications on the same day, emphasizing statutory factors and eliminating certain expedited review processes. While these actions signal a more thorough evaluation process, they also introduce the possibility of diverging approaches between the DOJ and federal banking agencies, as each entity retains its authority to evaluate mergers within its own regulatory framework.


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