

2019 Annual Credit Union Seminar

ACCOUNTING UPDATE

Presented By:

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› Today's Topics

- CECL
- Leasing
- Revenue Recognition
- Financial Instruments
- Cloud Computing Arrangement (CCA) Accounting

CECL

(CURRENT EXPECTED CREDIT LOSS)

› CECL

Effective date: January 1, 2023 – for calendar year-ends, just extended!

Transition: Adjustment to the allowance will be made to undivided earnings on January 1, 2023, per above

Early adoption is permitted

ALLOWANCE FOR LOAN LOSSES – CURRENT GAAP

➤ Allowance for Loan Losses (ALL)

What the ALL represents:

- The ALL is an accounting estimate of credit losses inherent in an institution's loan portfolio that have been incurred as of **the statement of financial condition date**.
- A loan is impaired when, based on **current information** and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement.
- This is the “incurred loss” threshold model.

➤ Allowance for Loan Losses (ALL)

The allowance for loan losses is composed of the following:

- Individual loan impairment/reserve valuations (GAAP guidance Accounting Standards Codification (ASC) 310-10-35, previously FAS 114). TDR's are incurred in this component.
- General reserve calculations for homogeneous loan pools including (GAAP guidance ASC 450-20, previously FAS 5):
 - Historical loss rate calculations; and
 - Qualitative factor adjustments.

➤ Allowance for Loan Losses (ALL)

Key qualitative factors that financial institutions should consider when analyzing the ALL relative to adjustment of historical loss rates:

- Changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off and recovery practices not considered elsewhere in estimating credit losses.
- Changes in international, national, regional, and local economic and business conditions and developments that affect the collectability of the portfolio, including the condition of various market segments.
- Changes in nature and volume of portfolio and in the terms of loans.

➤ Allowance for Loan Losses (ALL)

Key qualitative factors that financial institutions should consider when analyzing the ALL relative to adjustment of historical loss rates:

- Changes in the experience, ability and depth of lending management and other relevant staff
- Changes in the volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans
- Changes in the quality of the institution's loan review system

➤ Allowance for Loan Losses (ALL)

Key qualitative factors that financial institutions should consider when analyzing the ALL relative to adjustment of historical loss rates:

- Changes in the value of underlying collateral of collateral-dependent loan
- The existence and effect of any concentrations of credit, and changes in the level of such concentrations
- The effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's existing portfolio
- Evaluate **EVERY ONE** of these qualitative factors and then conclude whether they negatively, positively or have no effect on your analysis of the ALL

› What is CECL?

CECL = Current Expected Credit Loss

What's changed from Incurred Loss Model?

1. **Forward looking requirements** - The proposal requires that forward looking information and forecasts are considered for the estimation of credit losses. This is a critical change from the current model's reliance on "incurred" losses to estimate loss rates
2. **"Probable loss" threshold removed** - The "probable" threshold for loss recognition used in the current guidance is removed, leaving institutions to evaluate whether or not a loss exists **at that time for the financial asset**. The removal of this threshold could accelerate the timing for when institutions are required to recognize impairment

› What is CECL?

What's changed from Incurred Loss Model? (continued)

3. **Need for accessible, loan-level data**
4. **Longer loss horizon - Loss estimates would use the lifetime of the credit instrument as the time horizon as opposed to the next 12-month period.** These forecasted estimates will need to be defensible, which could be particularly challenging for longer term loans
5. **Makes ALL more institution-wide calculation – not just accounting anymore**

➤ What is CECL?

Standard will require an entity to recognize an allowance for expected credit losses on financial assets, defined as: **"an estimate of contractual cash flows (P&I) not expected to be collected from a recognized financial asset (or group of financial assets) or commitment to extend credit"**

- Based on relevant information about past events, current conditions and reasonable and supportable **forecasts** that affect the expected collectability of the financial assets' remaining contractual cash flows
- Includes quantitative and **qualitative** factors specific to borrowers and the economic environment in which the entity operates. In addition to evaluating the borrowers' current creditworthiness, the assessment includes an evaluation of **forecasted direction of the economic cycle**
- **Requires evaluation of financial assets on a collective basis when similar risk characteristics exist. Examples would include auto loans, credit card loans, first mortgages, home equity loans and commercial loans**

Implementation Committee

- Notice how the allowance calculation flows through your credit union and how many areas touch it
- Strive for senior level representation across all departments
- CECL will require significant collaboration across functional areas



LOSS METHODOLOGIES UNDER CECL

Multiple Methodology Considerations

- **Discounted cash flow**
 - + Flexible loss application and forecasting (loss curve)
 - + Wide array of applications
 - - Requires a more technical analysis
 - - Loan level
- **Loss rate**
 - + Some inputs are common in today's incurred loss model
 - + Historical data is typically readily available
 - - Difficult to include exogenous risk factors and amortization
- **Roll Rate/Migration**
 - + Good for short-term forecasting
 - - Difficult to include exogenous risk factors and amortization
- **Vintage**
 - + Inclusion of maturation/duration information provides for flexibility
 - + Suited for installment loans

› Other Considerations

- **Forecasting**
 - An entity shall make reasonable and supportable forecasts and consider adjusting historical loss rates
- **Contractual Term**
 - Must consider prepayments as separate input or they must be embedded in the loss experience 326-20-30-5,6
 - May not extend term unless there is a reasonable expectation of a TDR
- **Merged Entities – Lack of Loan Level Historical Data**

› Outsourcing CECL

- Vendor due diligence
- Accounting standard's requirements matched to vendor's methodology/approach
- Specific Credit Union experiences
- Can you do this internally/on your own?

› Outsourcing CECL

- **Potential vendor partners:**
 - ABRIGO (Sageworks)
 - Visible Equity
 - 2020 Analytics
 - ARCSys

QUESTIONS?

THE NEW LEASE ACCOUNTING STANDARD

› Agenda

- Introduction
- Lease Identification and Classification
- Lessee Accounting

➤ Introduction

Current Environment

- Operating leases not recognized on the balance sheet
 - Most leases are off-balance-sheet but disclosed in footnotes
 - Existing GAAP contains two very different accounting outcomes for economically similar transactions
 - a. Operating lease
 - b. Capital lease
- Users seeking transparency & comparability
 - **Structured transactions**
 - Inconsistent 'add-backs' in the creditor & investor community for off-balance-sheet leases
 - Financing & leverage comparisons between similar firms

➤ Introduction

Financial Statement Impact

- Lessees are **required** to recognize lease assets and lease liabilities on the balance sheet for all leases with terms **longer than 12 months**. Lease terms of 12 months or less at commencement that do not include an option for the lessee to purchase the underlying asset that is reasonably certain to be exercised will continue to be expensed as incurred
- Classified as either **finance** or **operating** (classification affects pattern of expense recognition in income statement)

➤ Introduction

Effective Date, Scope and Transition

- Effective Date will be for year ends **beginning** after December 15, 2020 for private companies (December 31, 2021 year-ends), just extended!
- Early adoption is permitted
- Some lease exceptions exist

➤ Introduction

Effective Date, Scope and Transition (continued)

- Will apply to all applicable leases existing at “the beginning of the first comparative period” present upon adoption
 - No grandfathering of existing leases
- Transition of existing leases
 - Existing operating leases remain operating leases
 - Existing capital leases become finance leases
 - But ALL are recognized on the balance sheet

› Key Provisions

- Lease identification
- Classifying a lease
 - Financing or Operating
- Accounting for leases - lessee
 - Initial & subsequent
- Presentation of leases - lessee

➤ Lease Identification and Classification

Lease Identification

At inception of a contract, an entity should determine whether the contract is or contains a lease

Lease Definition:

A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (*an identified asset*) for a period of time in exchange for consideration

➤ Lease Identification and Classification

Lease Classification

Finance or Operating?

FINANCE lease if one of the following applies:

- 1** - The lease transfers ownership of the underlying asset to the lessee by the end of the lease term
- 2** - The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise
- 3** - The lease term is for the major part of the remaining economic life of the underlying asset

➤ Lease Identification and Classification

Lease Classification (continued)

Finance (continued)

- 4 - Net present value of the lease payments is substantially all of the fair value of the underlying asset
- 5 - The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term

Operating (continued)

- When 1 through 5 are not met, a lessee will classify the lease as an Operating lease.

› Lessee Accounting

At commencement, lessee's record ALL leases as follows (Finance and Operating):

- Recognize right-of-use (ROU) asset
- Record a lease liability for future rental payments

› Lessee Accounting

Measure **BOTH** the asset and the liability at present value (PV) of future lease payments,

- Based on both lease term and lease payments
- Discount at implicit interest rate within the lease:
 - If implicit rate is not readily determinable the lessee could use its incremental borrowing rate (the rate the company would incur for a similar debt instrument and related terms)
 - Lessees that are **not public entities** could make an accounting policy election and elect to use the **risk free rate** - using a period similar to the lease term

› Lessee Accounting

Two Elements Form the Basis for PV of Future Lease Payments:

1. Lease Term

- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option
- Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor. (assume the lessor will not cancel the lease)

› Lessee Accounting

2) Lease Payments Include:

- Fixed payments
- Variable lease payments that depend on an index or a rate
- The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option

› Lessee Accounting

2) Lease Payments Include (continued):

- Payments for penalties for terminating the lease
- Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction.
- For a lessee only, amounts **probable** of being owed by the lessee under residual value guarantees

› Lessee Accounting

Subsequent Accounting For Finance Leases

- Amortize ROU Asset
 - Method: straight-line basis, unless another basis is more representative
 - **Period: shorter of the estimated lease term or underlying asset's useful life**
- Separately Reflect in the Income Statement:
 - Interest expense component of the lease liability
 - Amortization of ROU asset
 - Variable lease payments incurred after commencement (that were not included in the original lease asset/liability)

› Lessee Accounting

Subsequent Accounting (continued) For Operating Leases

- Amortize ROU Asset
 - Difference between periodic lease cost and effective interest on lease liability
 - i.e. asset amortization is a “backed into amount”
- Reflect a single lease cost on the Income Statement
 - Combine effective interest on lease liability with amortization of ROU asset, so the remaining cost of the lease is allocated over the remaining lease term on straight-line basis

➤ Illustration – Financing Lease

Company enters three year equipment leases on Jan 1, Year1;
fixed payments as follows; implicit rate is 4.235%;
qualifies as financing lease

Payments	
Dec 31, Year1	\$ 10,000
Dec 31, Year2	\$ 12,000
Dec 31, Year3	<u>\$ 14,000</u>
	\$ 36,000
Implicit Rate	4.235%
Present value, Jan 1, Year1	\$ 33,000

Illustration – Financing Lease (continued)

Lease Commencement:

January 1, Year1	Debit	Credit
Right of Use Asset	33,000	
Lease liability		33,000
<i>Present value of lease payments at 4.235% discount rate</i>		

First-year Accounting Entries:

December 31, Year1	Debit	Credit
Lease liability	8,602	
Interest expense	1,398	
Cash		10,000
Amortization of lease liability per schedule		
Amortization expense	11,000	
Right of Use Asset		11,000
<i>Straight-line amortization of ROU asset, \$33,000 / 3 years</i>		

* $\$36,000 \div 3 \text{ years} = \$12,000 \text{ a year}$

➤ Illustration – Operating Lease

Company enters three year equipment leases on Jan 1, Year1; fixed payments as follows; implicit rate is 4.235%; **qualifies as operating lease**

Payments	
Dec 31, Year1	\$ 10,000
Dec 31, Year2	\$ 12,000
Dec 31, Year3	<u>\$ 14,000</u>
	\$ 36,000
 Implicit Rate	 4.235%
 Present value, Jan 1, Year1	 \$ 33,000

Same fact pattern and calculations as financing illustration

➤ Illustration – Operating Lease (cont.)

Lease Commencement:

January 1, 2020		Debit	Credit
	Right of Use Asset	33,000	
	Lease liability		33,000

First-year Accounting Entries

December 31, 2020		Debit	Credit
	Lease liability	8,602	
	Cash		10,000
	Rent/lease expense	12,000*	
	Right of Use Asset		10,602

* $\$36,000 \div 3 \text{ years} = \$12,000 \text{ a year}$

› Leases – Questions for Your Credit Union

- Status of leasing project? (New accounting standard)
- Inventory of existing leases:
 - Population
 - Terms
- Use of leasing software?
 - Captures all leases
 - Calculates accounting entities

QUESTIONS?

REVENUE RECOGNITION

➤ Revenue Recognition Accounting Standard - Purpose

- Establishes a new control-based revenue recognition model
- Changes the basis of deciding when revenue is recognized over time or at a point in time
- Provides new and more detailed guidance on specific topics
- Expands and improves disclosure about revenue

Effective date

Effective date of ASC 606	Calendar year end entities	June 30 year end entities
Public entities*, quarter and year beginning...	January 1, 2018	July 1, 2018
Other entities, year ending...	December 31, 2019	June 30, 2020
Early adoption of ASC 606		
Allowed for both public entities and other entities...	As early as January 1, 2017	As early as July 1, 2017

* Public entities include PBEs, not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market and (c) employee benefit plans that file or furnish financial statements to the SEC.

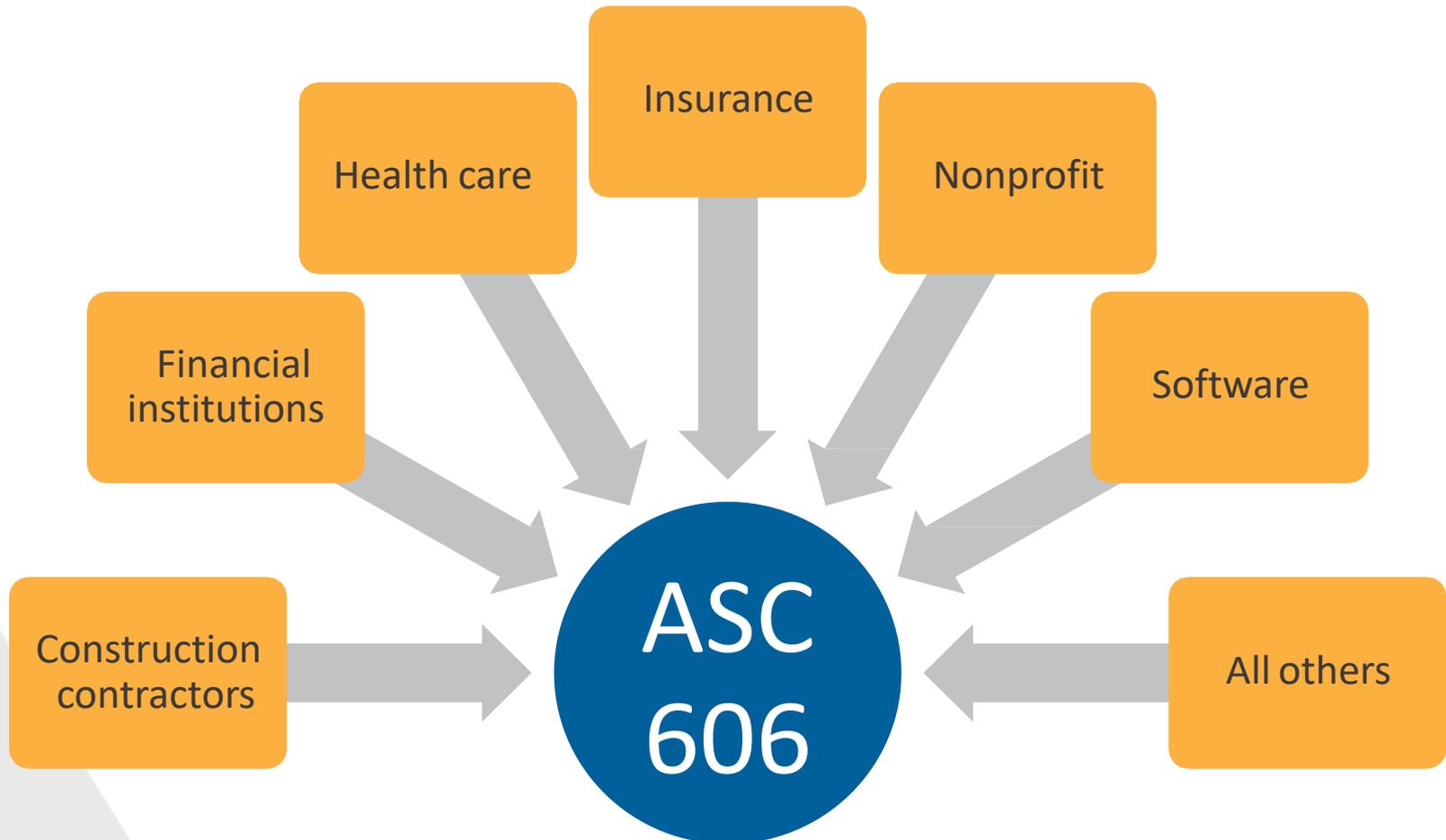
SCOPE

› Scope

- All revenue-generating contracts with customers are within the scope of ASC 606, except for:
 - Leases
 - Contracts within the scope of ASC 944 (insurance)
 - Various contractual rights or obligations related to financial instruments
 - Guarantees other than warranties
 - Certain nonmonetary exchanges

› Scope

No industries are scoped out of ASC 606!



› Scope

Definition of a customer: a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration

› Core principle

Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Key steps



› What Do You Need To Know

- Various whitepapers – Financial Institution specific
 - RSM
 - Crowe Horwath
 - E&Y
- AICPA whitepaper – general

➤ What's Out Of Scope For Financial Institutions?

- Covered by other accounting standards
 - Interest income on loans
 - Gain/loss on loan disposition
 - Interest income on investments
 - Gain/loss on investment dispositions
 - Credit card fees
 - Loan servicing fees
 - Derivatives

➤ What's In Scope For Financial Institutions?

- Share fees – ATM, NSF, Courtesy Pay
- Interchange income - Debit cards
- OREO sales

➤ Must Be Documented and Addressed By December 31, 2019

- Credit Union analysis of standard
- Document effect on Credit Union's accounting and reporting
- Disclosures – Credit unions have ability to opt out of the majority of disclosures
- RKL discussion and review with clients - Solution

QUESTIONS?

**FINANCIAL
INSTRUMENTS –
MEASUREMENT
ASU 2016-01**

➤ Financial Instruments - Measurement

- This standard (in draft form) started out a little “crazy”
 - Loans and deposits recorded at fair value
 - Changes in fair value run through the P&L

➤ Financial Instruments - Measurement

- Issued January 2016
- Effective for year beginning after December 15, 2018 – NOW!

› Financial Instruments - Measurement

- Does **NOT** change accounting for loans or shares
- Does require entities to measure **EQUITY** investments at fair value and recognize any **changes** in fair value in net income

➤ Financial Instruments - Measurement

- Specifics and exceptions
 - If equity investment is accounted for using the equity method – no need for fair value accounting (CUSO investments?)
 - Equity investments that do **NOT** have readily determinable fair value (CUSO investments that are recorded at cost.)
 - Measure at cost
 - Less impairment, if appropriate

➤ Financial Instruments - Measurement

- Specifics and exceptions
 - **“Managed Investment Accounts” – employee benefits**
 - Usually hold marketable equity securities
 - Historically classified as available-for-sale
 - Now need to be recorded at fair value
 - **No longer required to disclose the fair value of financial instruments in your footnotes**

QUESTIONS?

**INTERNAL USE
SOFTWARE CLOUD
COMPUTING
ARRANGEMENTS
(AS A SERVICE)**

› Internal Use Software

- Cloud computing – As a service
- Aligns accounting with existing internal use software accounting

› Internal Use Software

- Defines implementation costs that are to be capitalized or expensed
- Three stages:
 - Preliminary Project stage
 - Application Development stage
 - Post Implementation/Operation stage

› Internal Use Software

- Preliminary Project Stage (Expensed)
 - Conceptual formation of alternatives
 - Evaluation of alternatives
 - Determination of existence of needed technology
 - Final solution of alternatives

› Internal Use Software

- Application Development Stage (Capitalize)
 - Design of chosen path, including software configuration and software interfaces
 - Coding
 - Installation to hardware
 - Testing, including parallel processing phase
- Capitalize as a prepaid **NOT** an intangible

› Internal Use Software

- Post Implementation/Operation Stage (Expensed)
 - Training
 - Application maintenance

› Internal Use Software

- Effective for years beginning after December 15, 2020
- Early adoption allowed

QUESTIONS?

THANK
YOU!