Accounting & Auditing Update For Financial Institutions

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Accounting and Auditing Update

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Accounting and Auditing Update

- Agenda
  - Accounting Update
  - Questions

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Accounting Update

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Revenue Recognition

ASU 2014-09	Revenue Recognition
Scope	Contracts to sell goods, services, or a nonfinancial asset, excluding certain contracts, such as insurance and leases
Effective	**PBE:** Beginning after December 15, 2017 **Non-PBE:** Beginning after December 15, 2018 (Early adoption is permitted for periods beginning after December 15, 2016)
Highlights	Broad principles-based standard for recognizing revenue from contracts

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Revenue Recognition

- Does not impact:
  - Interest income
  - Premium/discount amortization
  - Mortgage servicing income
  - Loan prepayment fees
  - Late fees
  - Loan origination fees
  - Loan commitment fees
  - BOLI

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Revenue Recognition

- Sales of ORE:
  - Removes the specific bright line tests for down payment, ability to repay, etc.
  - Only 2 methods of accounting – full accrual or deposit method
  - It seems likely down payment, ability to repay, etc., will continue to be considered when determining whether a sale has occurred (that is, whether you have a contract)

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Revenue Recognition

- Deposit fees:
  - Contracts are typically day-to-day contracts since customers can cancel the contract (i.e., remove their deposit) at any time without any significant penalty
  - If the contract does not extend beyond the period in which services are performed (wire transfer, ATM usage, overdraft payment, etc.), the revenue is recognized when the fee is charged

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Revenue Recognition

- Interchange fees:
  - Probably the biggest question is whether the institution is a principal or an agent; the difference is whether revenue and expense are presented gross or net in the income statement

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Revenue Recognition

- Trust and wealth management fees:
  - Customers can usually remove their funds at will, so similar to deposit fees, these fees will usually be recognized when earned for the services provided to date
    - Fee earned and recognized at the end of each month/quarter
  - Will need to review contracts more closely when terms do not allow customers to withdraw funds at will

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Revenue Recognition

- Insurance policy commissions:
  - What does the contract say?
  - Are there variable components?
  - Do we need to apply the "constraint?"
  - When have we completed our performance?

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Revenue Recognition

- What should institutions do to prepare?
  - Review various revenue-generating activities (e.g., noninterest income) – identify what is in scope
  - Identify material activities that are in scope
  - Follow the five-step process to determine and document appropriate accounting treatment
    - Look at contracts; don't just rely on "understanding"
  - Look at public company filings for disclosure samples
  - Implement controls/processes to detect new revenue streams

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Measurement of Financial Instruments

ASU 2016-01	Recognition and Measurement of Financial Assets and Liabilities
Scope	Entities with financial instruments
Effective	**PBE:** Beginning after December 15, 2017 **Non-PBE:** Beginning after December 15, 2018
Highlights	New recognition and measurement model for financial assets and liabilities

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Measurement of Financial Instruments

- **Equity** investments
  - Equity method investments – No change
  - Readily determinable fair value – Fair value with changes in fair value recognized in net income (FVNI)
  - No readily determinable fair value – FVNI, except entity may choose to measure at:
    - Cost, minus impairment
    - Plus/minus observable price changes for identical or similar investment of same issuer

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Measurement of Financial Instruments

- Equity investments – Impairment
  - Simplified to require a qualitative assessment
    - If qualitative assessment indicates impairment, recognize at fair value
- Non-PBEs do not have to disclose fair value of financial instruments measured at amortized cost (f/k/a FAS 107 disclosure)

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Measurement of Financial Instruments

- PBEs do not have to disclose methods and significant assumptions in FAS 107 disclosure
- Requires PBEs to use exit price notion for FAS 107 disclosure
- Financial liabilities measured at fair value using the fair value option:
  - Change in fair value resulting from change in credit risk recognized in comprehensive income

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Measurement of Financial Instruments

- Separate presentation of financial instruments on balance sheet or in notes by measurement category and form of asset/liability
- Entity should evaluate the need for a valuation allowance on a deferred tax asset related to securities available for sale in combination with other deferred tax assets

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Measurement of Financial Instruments

- At adoption:
  - Cumulative effect adjustment for the first period presented
  - Option related to equity investments with no readily determinable fair value is recognized on a prospective basis

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Leases

ASU 2016-02	Leases
Scope	Entities with leases (lessees and lessors)
Effective	**PBE:** Beginning after December 15, 2018 **Non-PBE:** Beginning after December 15, 2019 (Early adoption is permitted)
Highlights	New recognition and measurement model for leases – primary change is that a right-of-use asset and lease obligation will be recognized for operating leases

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Leases

"One of my great ambitions before I die is to fly in an aircraft that is on an airline's balance sheet."

—Sir David Tweedie, Former Chairman of the IASB, April 25, 2008

Primary change in the new standard is to recognize a right-of-use asset and lease obligation for operating leases

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Leases

- What's not changing:
  - Lessor accounting remains fairly unchanged
    - Eliminates real estate provisions and leveraged leases
    - Some change for what qualifies as an initial direct cost
  - Definition of a lease was clarified
  - Still two types of leases – operating and finance
  - Expense recognition of leases should be similar
    - Finance – Asset amortization and interest expense
    - Operating – Lease (rent) expense on a straight-line basis

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Leases

- What is changing:
  - All leases (including operating leases) with a lease term greater than 12 months will be recognized on the balance sheet
  - Bright-line finance (capital) lease tests are removed

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Leases

- What is changing:
  - Non-lease components are separated from the lease unless a practical expedient is elected
  - It will change profit recognition for sale-leaseback transactions
  - Related-party leases are accounted for based on the contractual obligations of the lease (not the substance)
  - There are new disclosure requirements

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Leases

- Lease classification criteria are now principles based:
  - Property transfers to the lessee
  - Lessee is reasonably certain to exercise purchase option
  - Lease term is for a "major" part of asset's economic life
  - Present value of lease payments equals or exceeds "substantially all" of the fair value of the asset
  - *(New)* Asset is very specialized (no alternative use) – meant to be applied in rare circumstances
- If any apply, this is a finance lease

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Leases

- For both operating and finance leases:
  - Right of Use (ROU) asset and lease obligations are recognized as the PV of lease payments
    - ROU asset is adjusted for initial direct costs, prepayments, and/or lease incentives
  - Exemption for short-term leases (lease term of 12 months or less)
    - Lease term will include renewal options if they are controlled by the lessor or if the lessee is reasonably certain to exercise them

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Leases – Finance Lease Example

Institution enters into a three-year equipment lease with monthly lease payments of $2,000. There are no initial direct costs, prepayments, or lease incentives.

	ROU Asset	Amortization	Lease Obligation	Interest	Total Expense
Initial	$ 61,983		$ 61,983		
Year 1	41,322	$20,661	43,342	$5,359	$26,020
Year 2	20,661	20,661	22,749	3,407	24,068
Year 3	0	20,661	0	1,251	21,912

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Leases – Operating Lease Example

Institution enters into a three-year equipment lease with monthly lease payments of $2,000. There are no initial direct costs, prepayments, or lease incentives.

	ROU Asset	Amortization (1)	Lease Obligation	Interest (1)	Lease Expense
Initial	$ 61,983		$ 61,983		
Year 1	43,342	$18,641	43,342	$5,359	$24,000
Year 2	22,749	20,593	22,749	3,407	24,000
Year 3	0	22,749	0	1,251	24,000

(1) Interest and amortization numbers are shown for information but are not separately recognized in the income statement – the total is recognized as "lease" expense

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Leases

- Sale-leaseback accounting changes:
  - Determine if a sale occurred using new revenue recognition guidance
  - If sale occurred, recognize gain in accordance with new revenue recognition guidance and account for the leaseback as a lease
  - Finance leaseback precludes a sale
  - Adjustments required for off-market terms

Leases

- Sale-leaseback accounting changes:
  - May be able to utilize this to increase capital **in the short term**, but you should consider the following:
    - If the standard is early adopted, applies to all leases
    - May not be much capital, especially after tax
    - ROU assets will be added to denominator (decrease capital ratios)
    - Will probably cost the institution more in the long run

Leases

- Related-party leases
  - *Current rule:* Account for the substance of the lease
  - *New rule:* Account for the contractual obligation
  - Still have to consider all of the lease criteria
  - Watch out for impact on leasehold improvements
  - Safety and soundness issue?

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Leases

- Adoption
  - Modified retrospective or cumulative effect adjustment
  - Practical expedients:
    - Package deal – Need not reassess:
      - Whether contracts contain(ed) leases
      - Lease classification
      - Initial direct costs
    - May use hindsight to determine lease term

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Leases

- Adoption
  - Existing leases are recognized as of the earliest financial statement period presented (need to start preparing earlier than the effective date)
  - Operating leases – ROU asset and lease liability measured using remaining payments
  - Finance (capital) leases – generally no change
  - Initial direct costs, prepayments, and lease incentives are reclassified as part of the ROU asset

Leases

- Adoption
  - Sale leaseback
    - Not reassessed if it already qualified as a sale
    - Reassessed if it did not previously qualify as a sale
  - Transition disclosures
    - Impact on financial statements
    - Use of practical expedient(s)

Leases

- What should institutions do to prepare?
  - Take an inventory of leases
  - Determine which adoption method will be used
  - Determine whether practical expedients will be elected
  - Identify the remaining term for leases that will still be outstanding at adoption
  - Consider how the institution will track and generate accounting entries for leases going forward

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Leases

- Other items
  - Impact on regulatory capital
  - If you would like some help estimating the impact of the lease standard, Wipfli has a lease analysis tool available
    - Please contact your Wipfli relationship executive

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Improvements to Share-Based Compensation

ASU 2016-09	Improvements to Employee Share-Based Payment Accounting
Scope	Entities with share-based compensation
Effective	**PBE:** Beginning after December 15, 2016 **Non-PBE:** Beginning after December 15, 2017 (Early adoption is permitted)
Highlights	Various changes that simplify accounting for share-based compensation

Improvements to Share-Based Compensation

- Highlights:
  - Excess tax benefits and tax deficiencies are recognized in income tax expense (previously recognized in paid-in capital)
  - Forfeitures – Entity may make accounting policy election to either estimate forfeitures or account for forfeitures when they occur
  - Nonpublic entities may make a policy election to estimate the expected term as the midpoint between the required service period and the contractual term

Measurement of Credit Losses

ASU 2016-13	Measurement of Credit Losses on Financial Instruments
Scope	Entities with financial assets
Effective	**SEC Filer:** Beginning after December 15, 2019 **Other PBE:** Beginning after December 15, 2020 **Non-PBE:** Beginning after December 15, **2021?** (Early adoption is permitted for periods beginning after December 15, 2018)
Highlights	New impairment model for loans and securities

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Measurement of Credit Losses

- Various resources and recorded webinars at:

  www.wipfli.com/FICECL

- For more information or implementation help or to set up a CECL Readiness Snapshot meeting, please contact your Wipfli relationship executive

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Statement of Cash Flows

ASU 2016-15	Statement of Cash Flows – Classification of Certain Receipts and Payments
Scope	Entities that prepare a cash flow statement
Effective	**PBE:** Beginning after December 15, 2017 **Non-PBE:** Beginning after December 15, 2018 (Early adoption is permitted)
Highlights	Updates presentation of certain cash receipts and cash payments in the statement of cash flows

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Statement of Cash Flows

- Updates statement of cash flow presentation in the following areas:
  - Settlement of zero-coupon and similar debt instruments
  - Proceeds from the settlement of insurance claims
  - Beneficial interests in securitization transactions
  - Separately identifiable cash flows and the application of the predominance principle

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Statement of Cash Flows

- Updates statement of cash flow presentation in the following areas:
  - **Debt prepayment or debt extinguishment costs**
    - Financing activity
  - **Distributions received from equity method investees**
    - Accounting policy election for one of two methods:
      - Cumulative earnings approach
      - Nature of the distribution approach

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Statement of Cash Flows

- Updates statement of cash flow presentation in the following areas:
  - **Contingent consideration payments made after a business combination**
    - Investing activity – Payments made soon after the acquisition date
    - Financing activity – Payments made not soon after the acquisition up to the liability recognized
    - Operating activity – Excess payments made not soon after the acquisition

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Statement of Cash Flows

- Updates statement of cash flow presentation in the following areas:
  - **Proceeds from the settlement of BOLI**
    - Investing activity – Proceeds from settlement of BOLI
    - Operating and/or investing activity – Premiums paid

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Goodwill Impairment

ASU 2017-04	Simplifying the Test for Goodwill Impairment
Scope	Entities with goodwill
Effective	**SEC Filer:** Beginning after December 15, 2019 **Other PBE:** Beginning after December 15, 2020 **Non-PBE:** Beginning after December 15, 2021 (Early adoption is permitted)
Highlights	Eliminated Step 2 from the goodwill impairment test

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Goodwill Impairment

- Goodwill impairment steps:
  - Step "0" – Qualitative assessment
  - Step 1 – Compare carrying basis of reporting unit (including allocated goodwill) to its estimated fair value
  - Step 2 (removed) – Estimate fair values of reporting unit's assets and liabilities and measure impairment based on implied goodwill
    - Instead, measure goodwill impairment based on difference between carrying basis and estimated FV of reporting unit (Step 1); also consider deferred tax

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Pension/Postretirement Benefit Cost

ASU 2017-07	Improving the Presentation of Net Periodic Pension/Postretirement Benefit Cost
Scope	All entities
Effective	**PBE:** Beginning after December 15, 2017 **Non-PBE:** Beginning after December 15, 2018 (Early adoption is permitted)
Highlights	Service cost component of net periodic benefit cost is separately reported from other components as part of employee compensation costs

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Premium Amortization

ASU 2017-08	Premium Amortization on Purchased Callable Debt Securities
Scope	All entities
Effective	**PBE:** Beginning after December 15, 2018 **Non-PBE:** Beginning after December 15, 2019 (Early adoption is permitted)
Highlights	Premiums on callable debt securities are amortized to the earliest call date

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Derivatives and Hedging

ASU 2017-12	Targeted Improvements to Accounting for Hedging Activities
Scope	All entities
Effective	**PBE:** Beginning after December 15, 2018 **Non-PBE:** Beginning after December 15, 2019 (Early adoption is permitted)
Highlights	Allows for additional risk component hedging; Simplifies and expands the availability of fair value hedging; Simplifies accounting, effectiveness assessments

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Derivatives and Hedging

- New provisions for fixed rate hedging
  - More options available for fair value hedges to better match the risk being hedged
  - Can use "last of layer" approach for loan pools
- Easier to hedge prime rate instruments
- More practicality to certain effectiveness testing
  - Qualitative assessments
  - Ineffectiveness no longer recognized separately for highly effective hedges

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Derivatives and Hedging

- There is also an opportunity to reclassify "qualifying" securities held to maturity to securities available for sale without tainting the rest of the HTM portfolio upon adoption of this standard

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Reclassification of "Stranded" Tax Effects

ASU 2018-02	Reclassification of Certain Tax Effects from AOCI
Scope	All entities
Effective	Beginning after December 15, 2018 (including interim periods) (Early adoption is permitted)
Highlights	Allows a reclassification of "stranded" tax effects resulting from the Tax Cuts and Jobs Act from AOCI to retained earnings

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Reclassification of "Stranded" Tax Effects

- Only applies to stranded tax effects resulting from the Tax Cuts and Jobs Act
- Does not change the recognition of the tax rate change in net income
- Reclassification between balance sheet accounts
- Amendments are applied:
  - In the period of adoption, or
  - Retrospectively to all affected periods
- Disclosures whether you adopt or not

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Fair Value Disclosures

ASU 2018-13	Changes to the Disclosure Requirements for Fair Value Measurement
Scope	All entities
Effective	Beginning after December 15, 2019 (including interim periods) (Early adoption is permitted – Can early adopt disclosure removals and modifications and delay adoption of disclosure additions)
Highlights	Changes (generally simplifies) disclosure requirements related to fair value measurements

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Fair Value Disclosures

- Disclosures removed:
  - Amount and reason for transfers between Level 1 and Level 2.
  - Policy for timing of transfers between levels.
  - Valuation processes for Level 3 fair value measurements.
  - Nonpublic entities – Changes in unrealized gains and losses for the period included in earnings for recurring Level 3 fair value measurements held at the end of the reporting period.

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Fair Value Disclosures

- Disclosures modified:
  - In lieu of a rollforward for Level 3 fair value measurements, a nonpublic entity is required to disclose transfers into and out of Level 3 and purchases and issues of Level 3 assets and liabilities.
  - When using NAV, an entity is required to disclose the timing of liquidation of an investee's assets and the date when restrictions from redemption might lapse *only if* the investee has communicated the timing to the entity or announced the timing publicly.

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Fair Value Disclosures

- Disclosures added (public business entities only):
  - The changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements held at the end of the reporting period.
  - The range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements.

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Defined Benefit Plan Disclosures

ASU 2018-14	Changes to the Disclosure Requirements for Defined Benefit Plans
Scope	Entities that sponsor defined benefit plans
Effective	**PBE:** Beginning after December 15, 2020 **Non-PBE:** Beginning after December 15, 2021 (Early adoption is permitted)
Highlights	Changes (generally simplifies) disclosure requirements related to defined benefit plans

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Defined Benefit Plan Disclosures

- Disclosures removed (not complete list):
  - The amounts in accumulated other comprehensive income expected to be recognized as components of net periodic benefit cost over the next fiscal year.
  - The amount and timing of plan assets expected to be returned to the employer.
  - Related-party disclosures about the amount of future annual benefits covered by insurance and annuity contracts and significant transactions between the employer or related parties and the plan.

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Defined Benefit Plan Disclosures

- Disclosures removed (not complete list):
  - Nonpublic entities – The reconciliation of the opening balances to the closing balances of plan assets measured on a recurring basis in Level 3 of the fair value hierarchy. (Nonpublic entities will be required to disclose separately the amounts of transfers into and out of Level 3 and purchases of Level 3 plan assets.)
  - Public entities – The effects of a 1% change in assumed health care cost trend rates for postretirement health care benefits.

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Defined Benefit Plan Disclosures

- Disclosures added:
  - The weighted-average interest crediting rates for cash balance plans and other plans with promised interest crediting rates.
  - An explanation of the reasons for significant gains and losses related to changes in the benefit obligation for the period.

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Implementation Costs – Cloud Computing

ASU 2018-15	Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract
Scope	All entities
Effective	**PBE:** Beginning after December 15, 2019 **Non-PBE:** Beginning after December 15, 2020 (Early adoption is permitted)
Highlights	Align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for internal-use software

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Accounting Update

- Other ASUs:
  - ASU No. 2017-05: *Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*
  - ASU No. 2017-09: *Scope of Modification Accounting (Stock Compensation)*
  - ASU No. 2017-11: *(1) Accounting for Certain Financial Instruments with Down Round Features and (2) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments*

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- Other ASUs:
  - ASU No. 2018-06: *Codification Improvements to Topic 942, Financial Services—Depository and Lending*
  - ASU No. 2018-07: *Improvements to Nonemployee Share-Based Payment Accounting*

Accounting Update

- A final note – Impact on your borrowers:
  - Revenue recognition
  - Leases
  - Proposed debt classification standard
- Borrower financial statements may see significant changes that could result in covenant violations
  - Consider proactive discussion with borrowers
  - May want to revise certain covenants in advance

Questions?

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