RKL LLP
NACUSAC ANNUAL CONFERENCE
June 2019
Accounting Update

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RKL'S FINANCIAL SERVICES INDUSTRY GROUP

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RKL's FI Industry – Committed to You

- 6 Partners & 3 Principals with a significant focus on FI
- Currently servicing clients in PA, NJ, DE, and MD
- Provide Audit Services to over 50 Credit Unions
- Internal Audit & Compliance Services to over 30 Credit Unions & 30 Banks
- Dedicated FI IT Specialists
- Active in FI Focused Professional Organizations
- Dedicated Thought Leadership Specialists
- 30+ team members with FI as an industry focus

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Core Services for Credit Unions

- Financial Statement Audits
- Supervisory Committee Audits
- Internal Audit Outsourcing & Co-Sourcing
- Compliance Reviews
  - (BSA, AML, HMDA, Fair Lending)
- Quarterly Supervisory Committee Assistance
- Information Technology Solutions
  - General control reviews
  - Penetration testing
  - Cybersecurity
  - Social awareness, and many more

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Today's Focus

- Accounting Update
- Current Key Accounting Issues Pertinent to Credit Unions
- Establish Basic Knowledge and Concepts
- Better Yet, Understand What Questions to Ask Your CEO and CFO Related to These Issues

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Today's Topics

- CECL

- LEASING

- REVENUE RECOGNITION

- FINANCIAL INSTRUMENTS

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CECL: A Discussion
(Current Expected Credit Loss)

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CECL

Effective date: January 1, 2022 – for calendar year-ends

Transition: Adjustment to the allowance will be made to undivided earnings on January 1, 2022

Early adoption is permitted

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Allowance for Loan Losses – Current GAAP

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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.

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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.

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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.

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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.

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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 loans.
- 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.

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What is CECL?

FASB released proposal December 2012

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.

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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.

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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.**

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What is CECL?

Purpose/why? - Quicker recognition of losses. Changes in ALL reserve balances will reflect changes in credit quality and flow through earnings. (“Fed Perspectives,” 2015)

Certainly a result of the world ending in 2008 and related huge loan losses as a result of the world ending.

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CECL Concerns

- How are future, life-of-loan losses reasonably predicted?
- **Even more subjective judgment is required (Forecasting economic cycles anyone?!)**
- Greater regulatory scrutiny
- Insufficient IT capabilities
- Lack/inaccessibility of data, especially for smaller credit unions
- Need to know where we are in the economic cycle

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CECL Concerns

- Implies we can identify when a downturn/recovery starts
- Implies we can predict the severity of a downturn
- Discourages longer-term lending
- Qualitative factors – Will need to consider both current and future conditions
- Requires more collaboration between Credit/Finance

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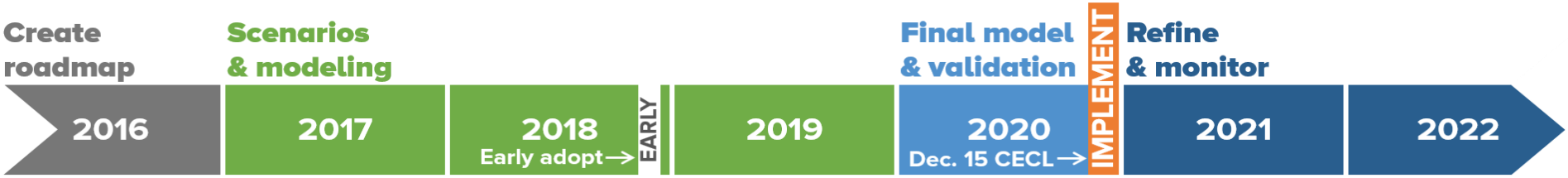
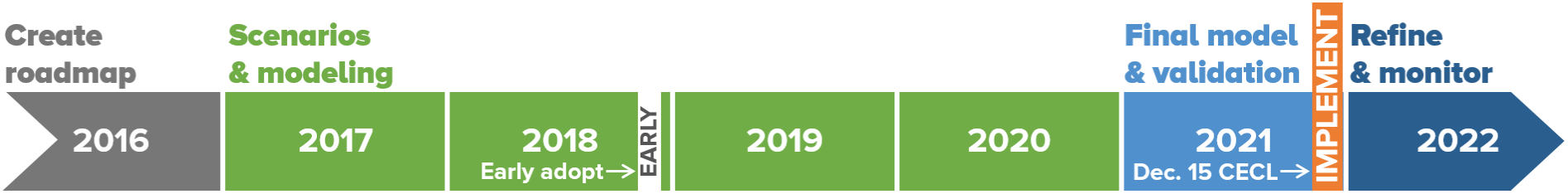
CECL Implementation Timelines

1. SEC Filing Institutions.

2. Non-SEC Filing Public Business Entities.



3. All Other Entities + Not-For-Profit Organizations.



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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

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Loss Methodologies Under CECL

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Multiple Methodology Considerations

- **Discounted cash flow**
  - + Flexible loss application and forecasting (loss curve)
  - + Wide array of applications
  - - Requires a more technical analysis
- **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

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Modeling Risk

- **Discounted cash flow**
  - Prepayment assumptions
  - Timing of expected defaults
  - Payment type assumptions
- **Loss rate**
  - Methodology – true forward looking loss rate?
  - Accurate segmentation loss rate; understand the connection between loan and loss
  - Application – Ensure loss rate inherently captures curtailments or adjust for them
- **Roll Rate/Migration**
  - Static look-forward?
  - Accurate segmentation loss rate; understand the connection between loan and loss
- **Vintage**
  - Rate calculation for application – sum remaining periods in life.
  - Calculation for periods that have yet to take place – new originations

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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**

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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?

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Outsourcing CECL

- Potential vendor partners:
  - Sageworks
  - Visible Equity
  - 2020 Analytics

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CECL - Questions to Ask Senior Management

- Status of Credit Union's CECL project?
- Is the Credit Union building sound historical charge-off detail at the loan level?
- Is the Credit Union engaging a third party to assist with implementation?
- When will actual methodology testing occur?

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QUESTIONS

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The New Lease Accounting Standard

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Agenda

- Introduction
- Lease Identification and Classification
- Lessee Accounting

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Why is this new lease standard being issued and what are some potential major impacts?

- **Why?** - The Financial Accounting Standards Board FASB) felt that the previous leasing guidance did not meet the needs of users of financial statements because it did not always provide a faithful representation of leasing transactions. In particular, **it did not require lessees to present assets and liabilities arising from operating lease activities**

- **Major Impact-**
  - Most common operating leases will be added to the balance sheet as an asset & liability

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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

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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)

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Introduction

EFFECTIVE DATE, SCOPE, and TRANSITION

- Effective Date will be for year ends **beginning** after December 15, 2019 for private companies (December 31, 2020 year-ends); one year earlier for public business entities
- Early adoption is permitted
- Some lease exceptions exist

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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

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Key Provisions

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

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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.

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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

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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:

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

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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

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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

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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)

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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

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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

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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)

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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

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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	$	14,000
	$	36,000
Implicit Rate		4.235%
Present value, Jan 1, Year1	$	33,000

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Illustration – Financing Lease (cont.)

Lease Commencement:

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

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
	Straight-line amortization of ROU asset, $33,000 / 3 years		

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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	$	14,000
	$	36,000
Implicit Rate		4.235%
Present value, Jan 1, Year1	$	33,000

SAME FACT PATTERN & CALCULATIONS AS FINANCING ILLUSTRATION

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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 ÷ 3 years = $12,000 a year

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Leases – Questions to Ask Senior Management

- Status of leasing project? (New accounting standard)
- Inventory of existing leases:
  - Population
  - Terms
- Use of leasing software?
  - Captures all leases
  - Calculates accounting entities
- What has been the input from the Credit Union's auditor?

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Revenue Recognition Under ASU 2014-09

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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

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Key Topics

- **Overall model** is based on transferring control instead of transferring risks and rewards of ownership
- **Collectability** assessment is different and the revenue recognition model used when collectability is not probable could result in delayed revenue recognition (even with respect to nonrefundable cash received)
- **Multiple-element arrangements** are subject to the following new requirements:
  - For separation purposes, must apply incremental criterion focused on whether a promised good or service is separately identifiable from other promised goods or services in the contract
  - For allocation purposes, must allocate discounts and (or) variable consideration to less than all performance obligations in certain circumstances
- **Warranties** are evaluated to determine if they represent a performance obligation to which revenue is allocated
- **Variable consideration** may be recognized earlier in certain circumstances

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Key Topics

- **Significant financing component** guidance is applied to both deferred and advance payments, which may result in the recognition of interest income (deferred payment) or interest expense (advanced payment)
- **Recognition of revenue over time or at a point in time** (i.e., whether control of a performance obligation's promised goods or services transfers over time or at a point in time) depends on whether one or more of three specific criteria are met
- **Balance sheet presentation** requires separate recognition of contract liabilities, accounts receivable and contract assets
- **Disclosure requirements** are significant and likely involve tracking (and disclosing) a variety of information not historically tracked or disclosed
- **Costs related to customer contracts** (e.g., costs to obtain or fulfill a customer contract) must be capitalized in certain circumstances

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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.

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Current and future state of affairs

- Final standards issued by FASB in May 2014
  - ASU 2014-09, Revenue from Contracts with Customers (Topic 606)
- Many changes made since issuance (clarifying changes)

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Current and future state of affairs

AICPA Task Forces

- Aerospace and defense
- Airlines
- Asset management
- Broker-dealers
- Construction contractors
- Depository institutions
- Gaming
- Health care
- Hospitality
- Insurance
- Not-for-profit
- Oil and gas
- Power and utility
- Software
- Telecommunications
- Timeshare

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Scope

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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

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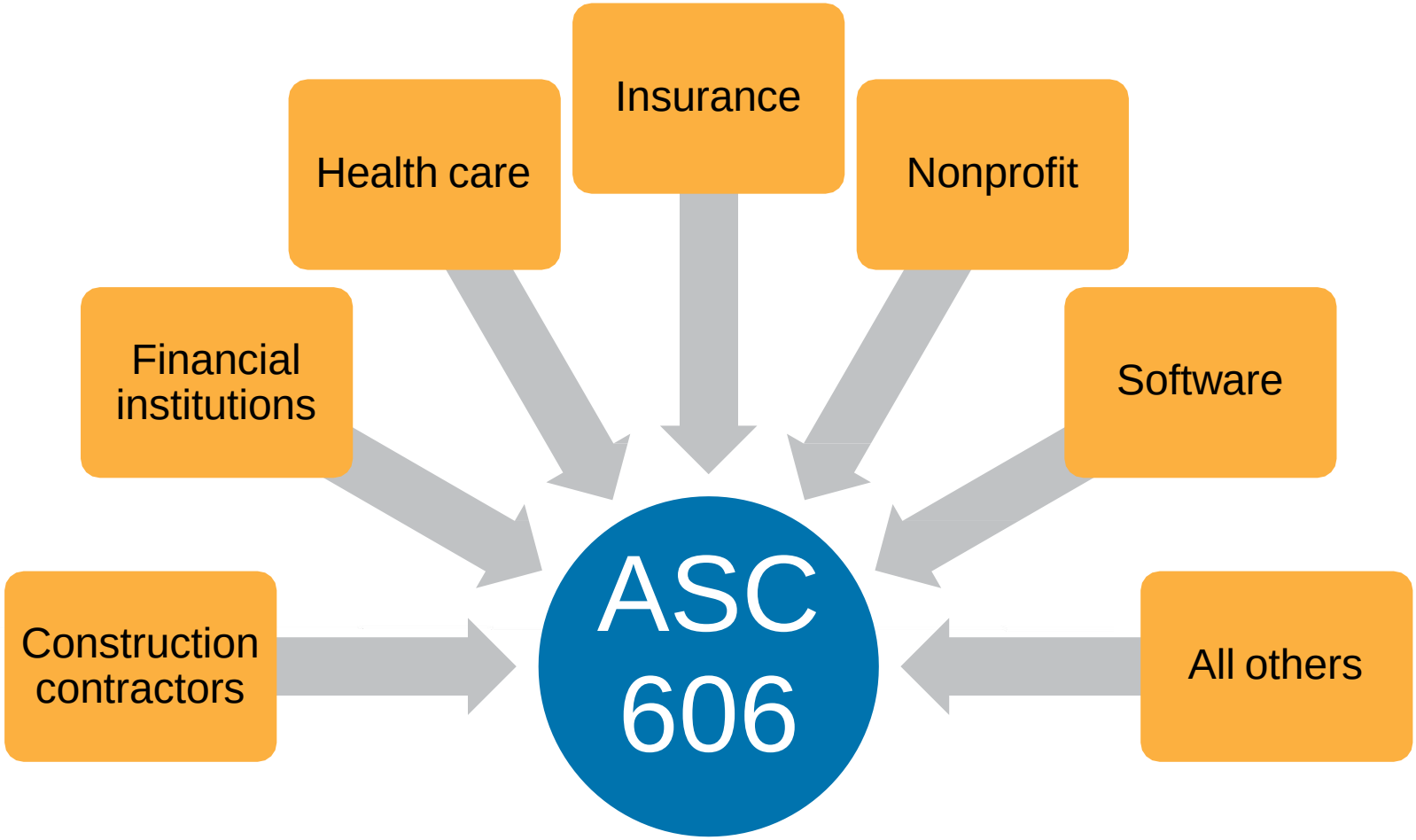
Scope

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.

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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.

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Key steps

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What Do You Need To Know

- Various whitepapers – FI specific
  - RSM
  - Crowe Horwath
  - E&Y

- AICPA whitepaper – general

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What's Out Of Scope For Financial Institutions?

- 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

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What's In Scope For Financial Institutions?

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

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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

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Revenue Recognition – Questions to ask Senior Management

- Status of managements review and understanding of the new standard?
- Input from the Credit Union's auditors?
- Credit Union's analysis of impact?

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FINANCIAL INSTRUMENTS – MEASUREMENT ASU 2016-01

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Financial Instruments - Measurement

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

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Financial Instruments - Measurement

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

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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.

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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

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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

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QUESTIONS

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Thank you!

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