VLI HAWAII 2019

ROCHDALE + PARAGON

ACCOUNTING STANDARDS UPDATE

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Objectives:

1. Review significant upcoming new accounting standards
2. Examine the level of potential impact of these standards on credit unions.
3. Discuss what institutions need to do to prepare for these standards.

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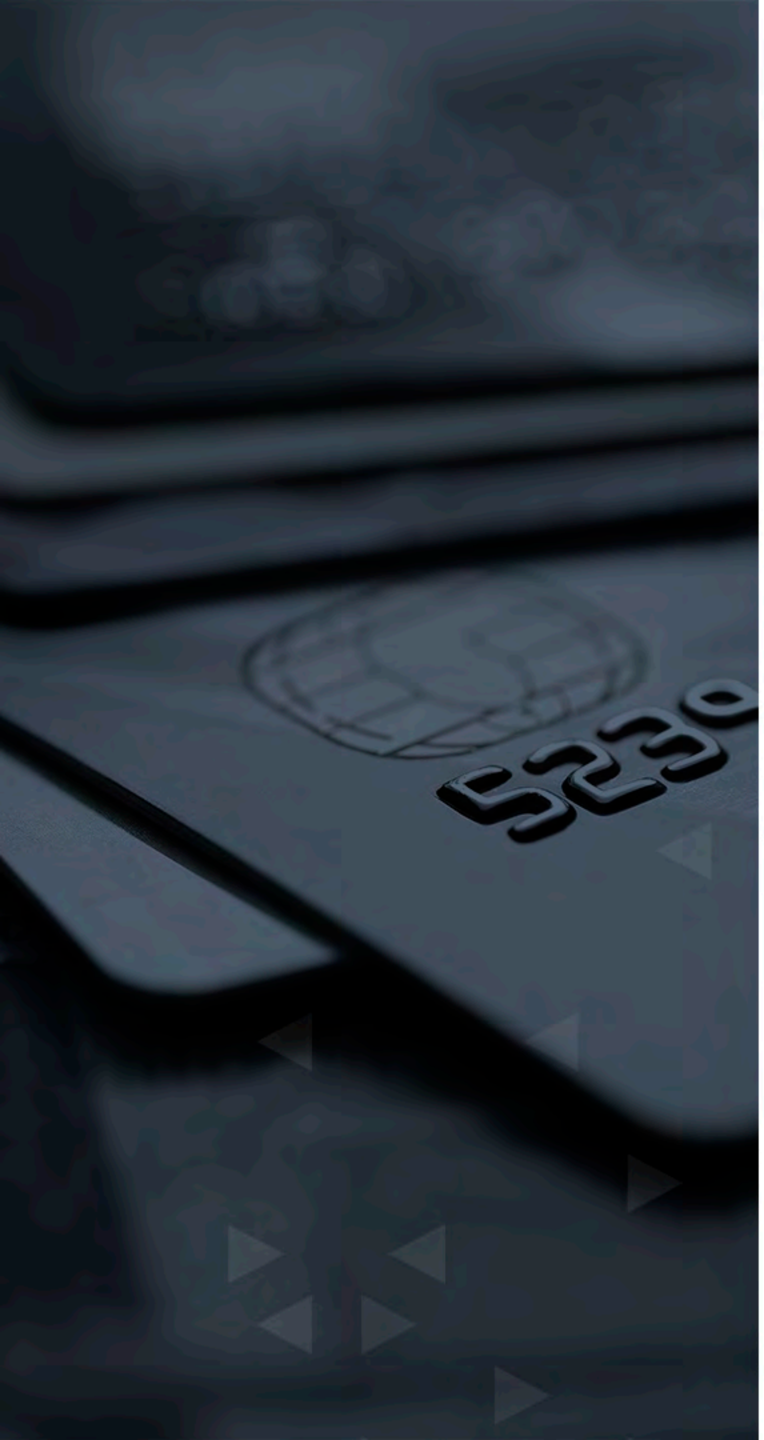

Accounting Standards Update

Volunteer Leadership Institute – Hawaii 2019

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February 7, 2019

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Today’s Goals

- Discuss key upcoming accounting standard changes for credit unions
- Understand how these standards may impact credit unions
- Discuss what credit unions should be doing to address these standards
- Provide key takeaways and resources for credit unions

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Opening Thoughts

- FASB has been very busy over the last 10 to 15 years
  - ✓Big 3 accounting standards and others
  - ✓Convergence
- Implementation of some of the upcoming standards will be significantly impactful on your resources and your financial statements
- As directors you can help provide management with accountability and support
- We are not covering every possible standard that will affect credit unions

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IMPLEMENTING NEW STANDARDS

FASB has created a resource for implementation guidance for major standards:

https://www.fasb.org/jsp/FASB/Page/BridgePage&cid=1176169238144

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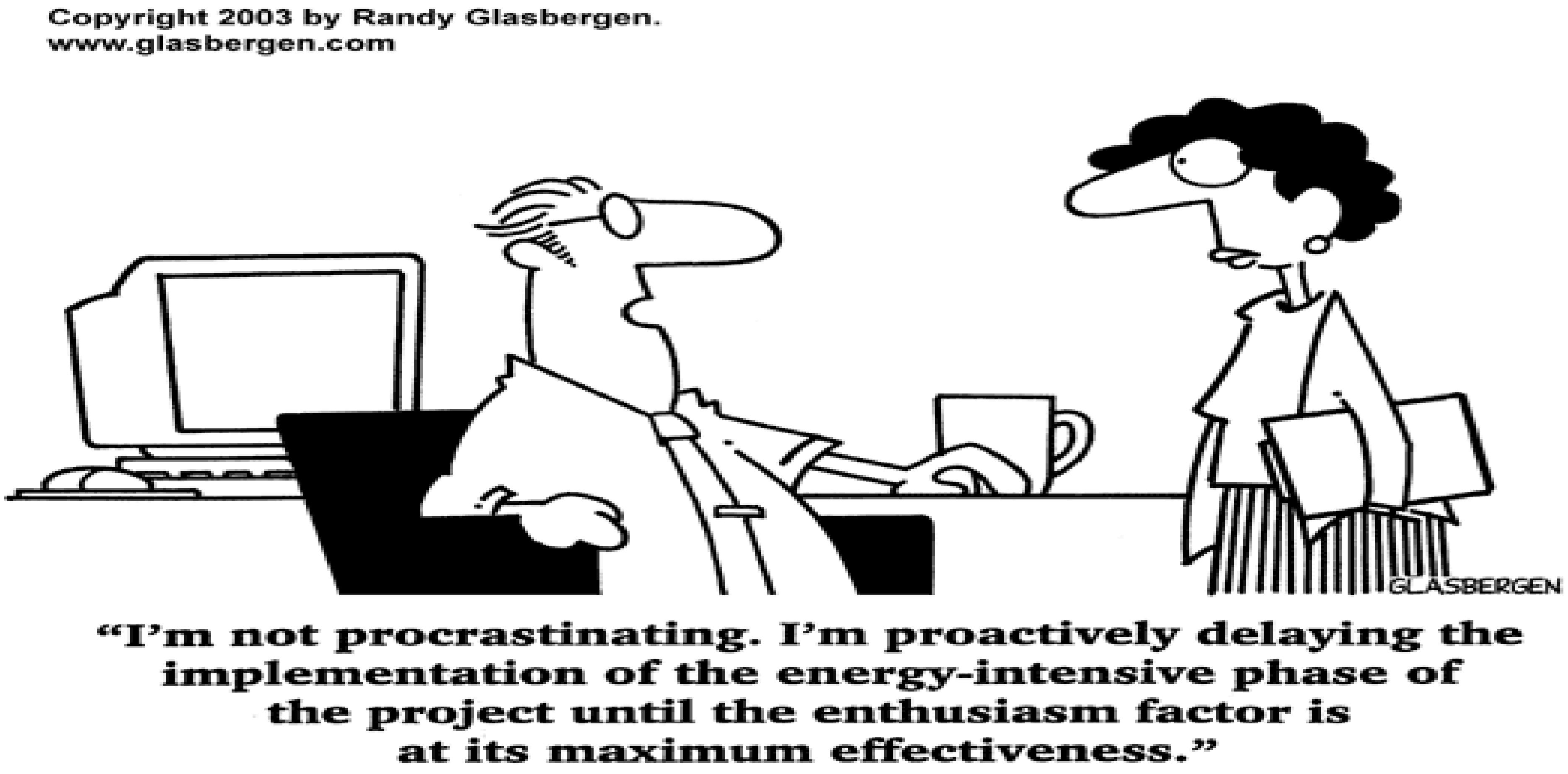
IMPLEMENTING NEW STANDARDS



Effective Dates for Credit Unions
(* Early Adoption Permitted)

2019

2014-09 Revenue Recognition

2016-01 Financial Instruments*

2017-01 Business Combinations

2020

2016-02 Leases

2017-08 Premium Amortization on Purchased Callable Debt Securities*

2017-12 Derivatives and Hedging

2022

2016-13 Credit Losses (CECL)*

2017-04 Simplifying the Test for Goodwill Impairment*

Potential Severity of Impact on Credit Unions

High Impact

2016-13 CECL

Moderate Impact

2016-02 Leases

2017-12 Derivatives and Hedging

Low Impact

2014-09 Revenue Recognition

2017-01 Business Combinations

2017-08 Premium Amortization

2016-01 Financial Instruments

2017-04 Simplifying the Test for Goodwill Impairment

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2014-09 Revenue Recognition

ASU 2014-09, Revenue From Contracts With Customers

- Step 1: Identify contract with customer
- Step 2: Identify performance obligations
- Step 3: Determine transaction price
- Step 4: Allocate transaction price
- Step 5: Recognize revenue

ASU 2014-09, Revenue From Contracts With Customers

Credit Union revenue deemed **out of scope** of ASU 2014-09:

- Interest income on loans & investments
- Loan origination fees
- Loan commitment fees
- Mortgage servicing income
- Prepayment fees
- Late fees

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ASU 2014-09, Revenue From Contracts With Customers

Credit Union revenue **in scope of** ASU 2014-09

- Deposit-related fees
- **Interchange income**
- Asset management fees
- **Sales of other real estate owned (ASC 610-20)**

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ASU 2014-09, Revenue From Contracts With Customers

Revenue recognition-what have we learned?

- From review of publicly traded community banks, impact generally has not been material
- Very limited impact on timing of recognition or gross versus net presentation of revenue
- Increased documentation to support conclusions
- Potential for impact on debt covenants with loan customers if your institution has business lending

ASU 2014-09, Revenue From Contracts With Customers

Most common areas of change

- Interchange revenue gross vs net determination
- Other real estate owned (updating internal policies and procedures)

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ASU 2014-09, Revenue From Contracts With Customers

- **Effective Date**
  - ✓Annual reporting periods beginning **after December 15, 2018** & interim reporting periods within annual reporting periods beginning after December 15, 2019

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Revenue Recognition Resources

Revenue Recognition: How It Affects Your Financial Institution

BKD Article

BKD Revenue Recognition Homepage

BKD Revenue Recognition Homepage

FASB Revenue Recognition Homepage

FASB Revenue Recognition

AICPA Revenue Recognition Homepage

AICPA Revenue Recognition Homepage

ASU 2016-01, Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities

ASU 2016-01, Financial Instruments – Recognition and Measurement

Multifaceted ASU targeting improvements to several financial instruments

For credit unions there are 2 major changes that may be impactful

- Fair value disclosures of financial instruments
- Changes to accounting for equity investments

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ASU 2016-01, Financial Instruments – Recognition and Measurement

- Credit unions and non public business entities are allowed to **remove** the fair value table disclosure for assets & liabilities recorded at amortized cost
  - ✓ Could (& should have) early adopt back in 2016 & forward

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ASU 2016-01, Financial Instruments – Recognition and Measurement

Fair Value of Financial Instruments

The following table presents estimated fair values of the Company's financial instruments at December 31, 20X2 and 20X1.

	20X2		20X1	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets				
Cash and cash equivalents	$	$	$	$
Accrued interest receivable				
Loans held for sale				
Loans				
Nonmarketable equity securities				
Mortgage servicing rights				

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ASU 2016-01, Financial Instruments – Recognition and Measurement

- Requires all equity investments to be measured at fair value with changes recognized in net income
  - ✓Eliminates cost method of accounting for equity investments without readily determinable fair value
- Specifically excludes FHLB & FRB stock
- Provides for an alternative for investments without readily determinable FV
  - ✓Allowing for cost minus impairment, if any, plus or minus changes resulting from observable price changes for the identical or a similar investment of the same issuer

Most common areas of impact

- No longer able to use available-for-sale equity security classification
- How to determine when you have observable price changes

ASU 2016-01, Financial Instruments – Recognition and Measurement

- **Effective Date**
  - ✓ Annual reporting periods beginning **after December 15, 2018**

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ASU 2017-01, Business Combinations (Topic 805)

ASU 2017-01, Business Combinations (Topic 805)

- Three elements to a business (also known as a set):
  - ✓ Inputs
  - ✓ Processes
  - ✓ Outputs
- Provide a screen to help determine when a set is not a business
  - ✓ Substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or group of similar assets – set is not a business
- If screen is not met – updated requirements related to inputs, processes and outputs

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ASU 2017-01, Business Combinations (Topic 805)

Key takeaways for credit unions

- Less transactions will qualify as business combinations
- Most impactful to credit unions buying existing branches from other institutions

ASU 2017-01, Business Combinations (Topic 805)

- **Effective Date**
  - ✓ Annual reporting periods beginning **after December 15, 2018**

ASU 2016-02, Leases

ASU 2016-02, Leases

- **Primary Objectives of the Standard**:
  - ✓Address the off-balance-sheet financing concerns related to lessees' operating leases by requiring almost all leases to be recorded on the balance sheet
  - ✓Lessor accounting is largely unchanged
  - ✓Change in definition for leases and focused on transfer of control and definition of control is in line with revenue recognition in Topic 606

ASU 2016-02, Leases

Key takeaways for credit unions

- Most **lessee** operating leases will now be recorded on the balance sheet
- Potentially more leases (imbedded leases)
- Most impactful to credit unions with a large leased branch network (impact on net worth ratio?)
- Understand transition, practical expedient and accounting policy elections

ASU 2016-02, Leases – Lessee Accounting

- Lessees will be required to recognize the following for all leases
  - ✓A lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis
  - ✓A right-of-use (ROU) asset, which is an asset that represents the lessee’s right to use, or control the use of, a specific asset for the lease term

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ASU 2016-02, Leases – Lessee Accounting

Leases will either be financing or operating

- Either way, they will be on balance sheet
- **Generally**, today's capital leases will be financing leases, & today's operating leases will be operating leases…but there are exceptions

Classification will be determined in accordance with the principles in current lease requirements, but without the bright-line tests

- Contains one additional criteria regarding specialized nature of the underlying asset

The ROU asset & lease liability will be recorded at the PV of lease payments using the discount rate, over the expected lease term

- Discount rate would be the rate implicit in the lease, or if none, the company's incremental borrowing rate
- Lease term includes option periods if it is reasonably certain that they will be exercised

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ASU 2016-02, Leases – Lessee Accounting

If Operating Lease

- ROU asset & Lease Liability will be the same initially under both scenarios
- Recognize lease expense in income statement
- Adjust lease liability to PV of remaining lease payments, with an offset to ROU asset

If Financing Lease

- Record interest expense using discount rate, with offset to lease liability
- Record amortization expense on the ROU asset

Transition Considerations

- Modified Retrospective vs. Prospective
- Practical expedients
  - ✓Use of the practical expedient package and hindsight package may ease operational burden of implementation
- Accounting policy elections
  - ✓Numerous items to be considered including materiality determination and discount rate

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ASU 2016-02, Leases

- **Effective Date**
  - ✓ Annual reporting periods beginning **after December 15, 2019**

Leases - Resources

BKD Leases Homepage:

BKD Thoughtware: Lease Accounting

FASB Leases Homepage:

FASB Leases

ASU 2017-08, *Premium Amortization on Purchased Callable Debt Securities*

ASU 2017-08, *Premium Amortization on Purchased Callable Debt Securities*

- **Purpose:** to amend the amortization period for certain purchased callable debt securities held at a premium to more closely align the amortization period to the expectations incorporated in market pricing on the underlying security
  - ✓ Requires the premium to be amortized to the earliest call date
  - ✓ Does not require an accounting change for securities held at a discount

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ASU 2017-08, *Premium Amortization on Purchased Callable Debt Securities*

Key takeaways for credit unions

- Determine how your credit union is amortizing premiums and discounts today
- Many credit unions are not following current GAAP
- If your credit union already amortizes to call for premiums – **EARLY ADOPT!**
- If your credit union is amortizing premiums to maturity vs call today, implementation may cause a decrease in earnings

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ASU 2017-08, *Premium Amortization on Purchased Callable Debt Securities*

- **Effective Date**
  - ✓ Annual reporting periods beginning **after December 15, 2019**

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ASU 2017-12, *Derivatives & Hedging: Targeted Improvements to Accounting for Hedging Activities*

ASU 2017-12, *Derivatives & Hedging: Targeted Improvements to Accounting for Hedging Activities*

In creating the standard, FASB sought to address concerns of both preparers who found hedge accounting rules burdensome and users who had difficulty understanding some of the presentations of hedge accounting information that exist under present GAAP including:

- Hedging prepayable instruments, *e.g.*, callable debt
- Partial-term fair value hedges
- Last of layer designation
- Determination of effectiveness of hedging

ASU 2017-12, *Derivatives & Hedging: Targeted Improvements to Accounting for Hedging Activities*

Key takeaways for credit unions

- Currently limited impact for credit unions
- May open the door for additional interest rate risk management strategies
- Purpose of standard is to simplify accounting and better align with institution’s risk management practices

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ASU 2017-12, *Derivatives & Hedging: Targeted Improvements to Accounting for Hedging Activities*

- **Effective Date**
  - ✓ Annual reporting periods beginning **after December 15, 2019**

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2016-13 Credit Losses (CECL)

2016-13 Credit Losses (CECL)

Key considerations for credit unions

- Most substantial accounting change in recent history
- Standard includes 2 different impairment models – CECL and AFS debt securities
- Of all upcoming standards, investment of time and resources is highest for CECL
- Use the time you have to educate and implement

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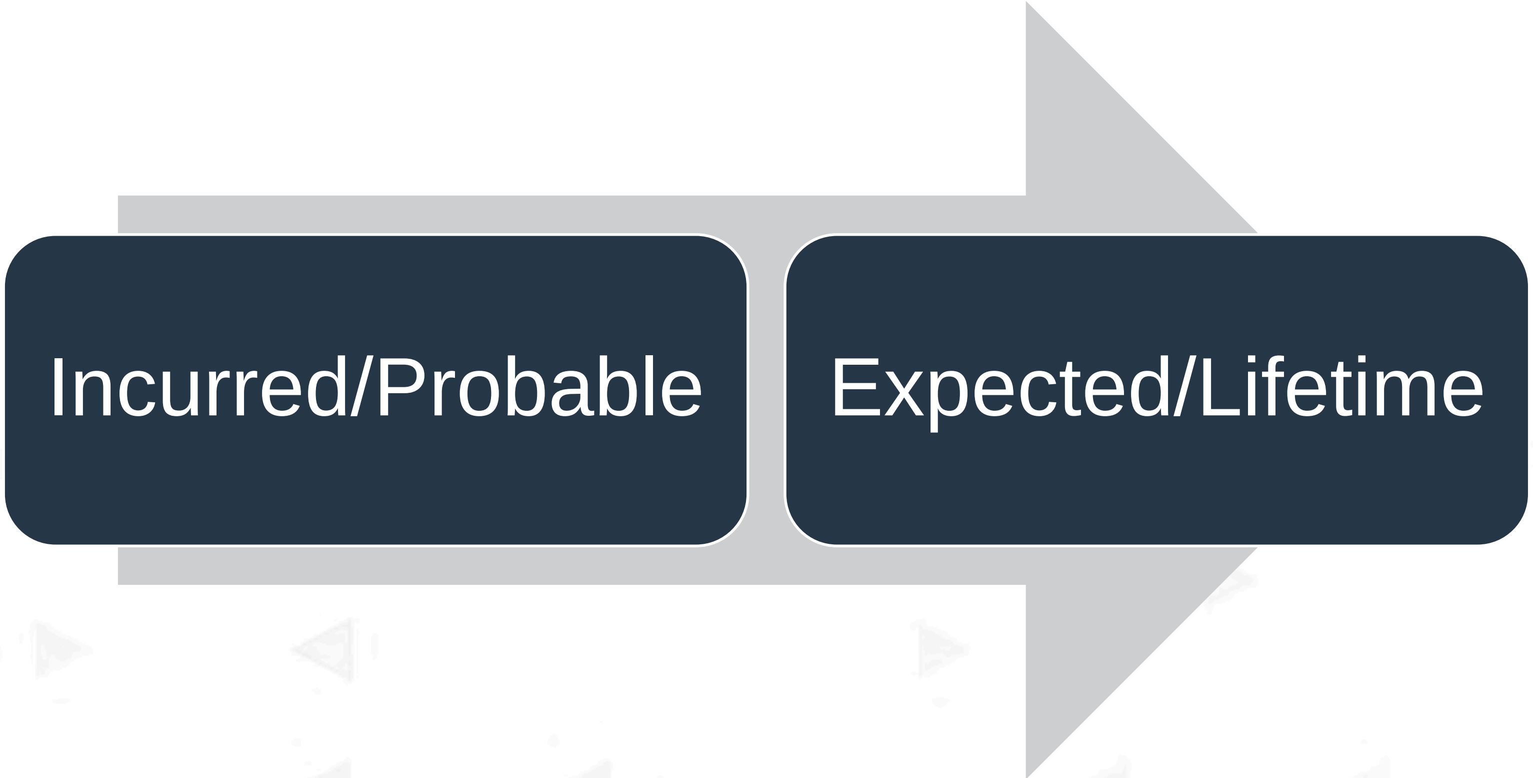
NEW IMPAIRMENT GUIDANCE (CECL)



Note: Incurred is typically considered a subset of expected

CECL SCOPE

INCLUDED	EXCLUDED
• Financing receivables • Held to maturity debt (no more OTTI) • Loan commitments, guarantees, standby L/C • Lease receivables as lessor (ASC 842) • Reinsurance receivables • Receivables on repurchase & securities lending agreements	• Financial assets at fair value • Available for sale debt (updated model) • Participant loans defined contribution benefit plans • Insurance policy loans • NFP pledges receivable

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CECL KEY HIGHLIGHTS

- Record estimate of expected lifetime credit losses (of amortized cost basis) over
  - Remaining contractual life based on
    - Historical experience
    - Adjustment for current conditions
    - Adjustments for reasonable & supportable forecasts
- Contractual life considers expected prepayments but excludes
  - Expected extensions, renewals & modifications unless expected to happen in a TDR

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CECL KEY HIGHLIGHTS

- Shall be measured on a collective pool basis based on similar risk characteristics unless the asset does not share similar risk characteristics
- For future periods where forecasts are not supportable entity shall revert to historical loss information either
  - Immediately
  - On a straight-line basis
  - Or using another rational & systematic basis

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CECL KEY HIGHLIGHTS

- Collateral-dependent practical expedient & TDR remain
- Estimate of expected credit losses shall include a measure of expected risk of credit loss even if that risk is remote
  - ✓ Can be very difficult to get to an answer of zero
- Does not prescribe a specific model or method to be used
  - FASB believes models do not need to be "unnecessarily complex"

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CURRENT CALCULATION (INCURRED)

By Loan Pool

Average 3-5 year historical loss rate + Qualitative loss factors + Specific allowance on impaired loans = Probable loss today

Individually Evaluated

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CECL CALCULATION (EXPECTED)

By Loan Pool

Historical Lifetime Credit Loss + Current conditions adjustment + Forecast adjustment + Individually unique loans = Current expected credit loss

Individually Evaluated

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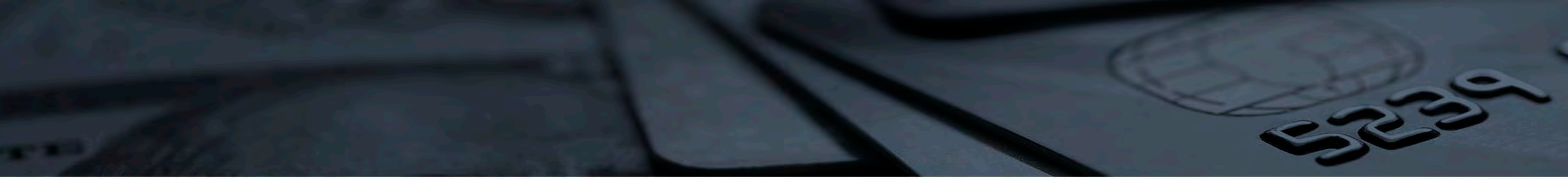
AVAILABLE-FOR-SALE SECURITIES

- Will now follow an allowance approach vs. direct write-off which will allow subsequent reversals
- Allowance would be limited to the amount which fair value is below cost
- Length of time fair value is below cost should not be considered in determining if any credit loss exists



REGULATORY EXPECTATIONS

FORMAL REGULATORY GUIDANCE

- *Joint Statement on the New Accounting Standard on Financial Instruments - Credit Losses* (June 2016)
- *Frequently Asked Questions on CECL* (Updated September 2017)
- *Proposed rule making (April 2018) on capital phase in (**does not apply to credit unions**)*

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KEY TAKEAWAYS

1. New standard will be scalable to all institutions
2. Smaller & less complex institutions will be able to adjust their existing allowance without the use of costly &/or complex modeling techniques
3. Inputs to allowance estimation methods currently used will need to change to properly implement CECL requirements
4. Won’t require institutions to engage third-party vendors to assist in implementing & calculating allowances within CECL
5. Institutions may need to capture additional data & retain data longer to meet CECL data requirements

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REGULATORY EXPECTATIONS

Regulators will begin, if they have not already, asking about CECL

Don’t be caught flat footed

Current focus will be in planning & readiness

CECL READINESS & IMPLEMENTATION PROCESS

Planning & Readiness

- Education
- Create committee & timeline
- Pool segmentation & credit risk identification
- Data inventory & gap analysis

Implementation

- Model(s) selection & development
- Model(s) finalization & parallel run
- Modify policies, procedures, controls & disclosures

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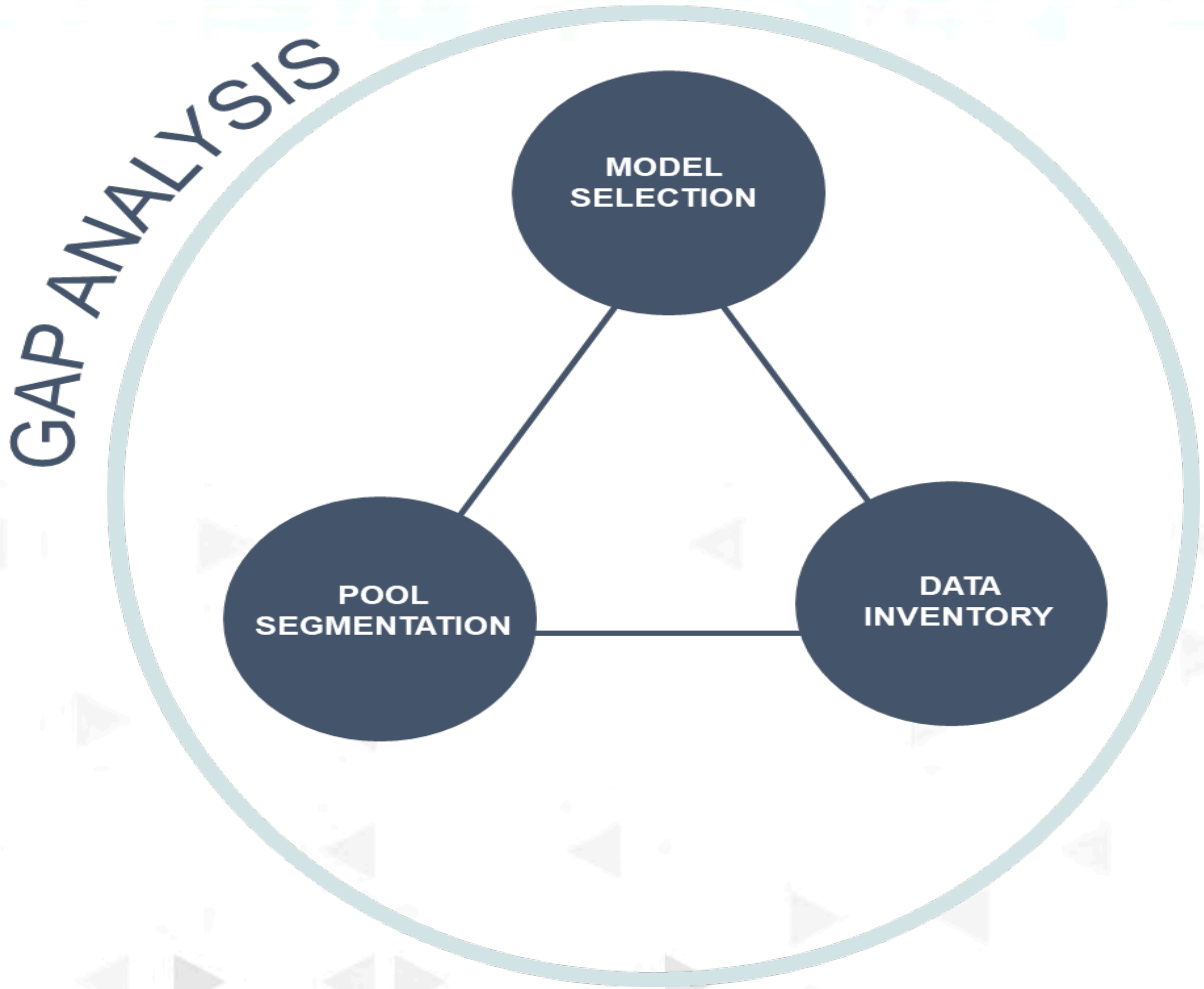
CECL – THREE KEY COMPONENTS TO FOCUS ON TODAY



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ASU 2016-13, *Credit Losses*

- **Effective Date**
  - ✓ Annual reporting periods beginning **after December 15, 2021**

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CECL- Resources

BKD CECL Homepage:

BKD CECL Resource Center

FASB CECL Homepage:

FASB Credit Losses

AICPA CECL Homepage:

AICPA Credit Losses

ASU 2017-04, *Simplifying the Test for Goodwill Impairment*

ASU 2017-04, *Simplifying the Test for Goodwill Impairment*

- Eliminated Step 2 from the goodwill impairment test
- Annual test should compare
  - ✓Fair value of a reporting unit
  - ✓Reporting unit’s carrying value

ASU 2017-04, *Simplifying the Test for Goodwill Impairment*

Key takeaways for credit unions

- Limited impact for credit unions
- This standard will decrease the effort and cost that currently exists for goodwill impairment testing
- Consider early adopting if potential impairment exists prior to effective date

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ASU 2017-04, *Simplifying the Test for Goodwill Impairment*

- **Effective Date**
  - ✓Annual reporting periods beginning **after December 15, 2021**

Questions?

Thank You!

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