FINANCIAL INSTITUTION AND SPECIALTY FINANCE

OVERVIEW OF 2014 REVENUE STANDARD

BIOGRAPHY

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Connie Becker has planned, supervised and participated in audits of clients in the Financial Services industry, including Banks and Thrifts. She has been servicing clients in this industry for over ten years and has participated primarily in financial statements audits and audits of internal controls over financial reporting. Connie's clients include private and public banks of all charters and size, from de-novo start ups to multi-branch, multi-billion dollar domestic institutions. She has been involved in various audit issues common to the banking sector such as: Troubled Debt Restructurings, Other than Temporary Impairment, Fair Value Measurements, Derivatives and Hedging and Business Combinations.

Learning Objectives

At the end of this session, participants will be able to:

- Identify key provisions of ASC Topic 606
- Describe the impact of ASC Topic 606 on the Financial Institutions & Specialty Finance industry
- Describe transition and implementation considerations for ASC Topic 606 relevant to the Financial Institutions & Specialty Finance industry

Discussion Outline

- Introduction and Adoption
- The ‘Five Step’ Model
- Other Key Areas
- Presentation & Disclosure
- Implementation

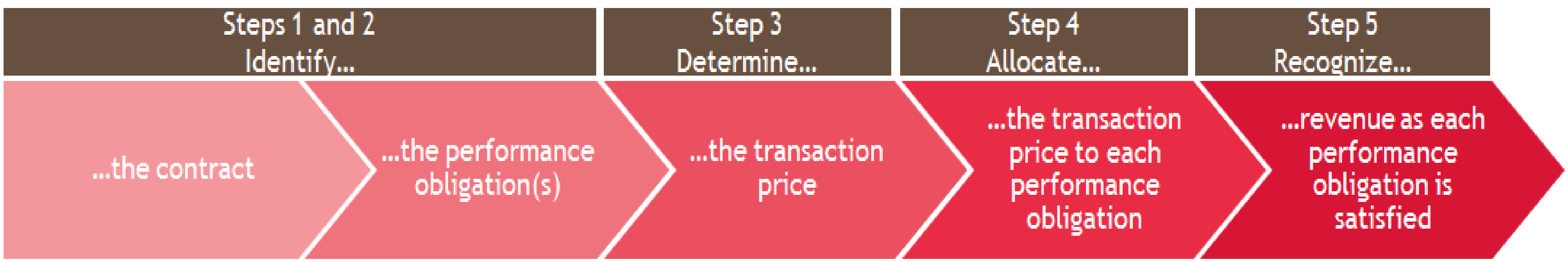
Introduction and Adoption

Introduction and Transition

Core principle:

Recognize revenue to depict the transfer of 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.

The five steps to apply the core principle are:



Introduction and Transition

Effective dates:

- Public entities - 1st interim period within annual reporting periods beginning after December 15, 2016
- Nonpublic entities - Annual reporting periods beginning after December 15, 2017 and interim periods within annual periods beginning after December 15, 2018
  - Early adoption permitted for nonpublic entities only but no earlier than periods beginning after December 15, 2016

Applies to contracts with customers. Some additional scope considerations apply.

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

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.

Introduction and Transition

ASC 606 is required to be applied retrospectively by one of the following methods:

1. Retrospective application to each reporting period presented in accordance with ASC 250-10-45-5 through 45-10 (i.e., full restatement of comparative figures).
2. Modified retrospective with one or more practical expedients (i.e., completed contracts, use of hindsight for variable consideration, etc.)
3. Cumulative effect of change at adoption date (disclose effect of applying new standard)

Introduction and Transition - Financial Institutions & Specialty Finance

The new standard does not apply to the primary contractual relationships banks and finance companies have with customers as financial instruments are specifically excluded from the scope of the new standard

Banks that issue credit cards may have specific aspects of the customer relationship which falls under new standard, which may affect:

- Interchange revenue for card issuing banks
- Rewards or other cardholder loyalty programs associated with the credit card relationship
- Annual fees may have different recognition criteria

To the extent a financial institution has real estate they are selling the revenue recognition may be accelerated under the new guidance.

The 'Five Step' Model

Step 1 – Identify the Contract

Step 2 – Identify Separate Performance Obligations

Step 3 – Determine the Transaction Price

Step 4 – Allocate the Transaction Price to Performance Obligations

Step 5 – Recognize Revenue

Step 1 – Identify the Contract

- Contracts can be written, oral, or implied by the entity's business practices.
- Contracts with customers must meet ALL the following criteria:
  i. The parties to the contract must approve it and be committed to perform their respective obligations;
  ii. Each party's rights regarding goods and services to be transferred can be identified;
  iii. The payment terms for goods and services to be transferred can be identified;
  iv. The contract must have commercial substance; and
  v. It is probable that the entity will collect the consideration to which it is entitled.
- Combining contracts - one or more contracts that are entered into at (or near) the same time with the same customer (or related party) are accounted for as a single contract if certain conditions are present.
- Contract modifications – may be treated as a separate contract, a termination, or a continuation depending on circumstances.

Step 1 - Financial Institutions & Specialty Finance Impact

A bank will need to exercise judgment when considering the terms of its contracts and the facts and circumstances. This also includes any implied terms. Consistency among contracts with similar terms will also need to be monitored. On both an interim and annual basis, a bank will generally have to provide more disclosures than it does today and include qualitative and quantitative information about its contracts with customers, significant judgments made in terms and in judgments and contract assets recognized from costs to obtain or fulfill a contract

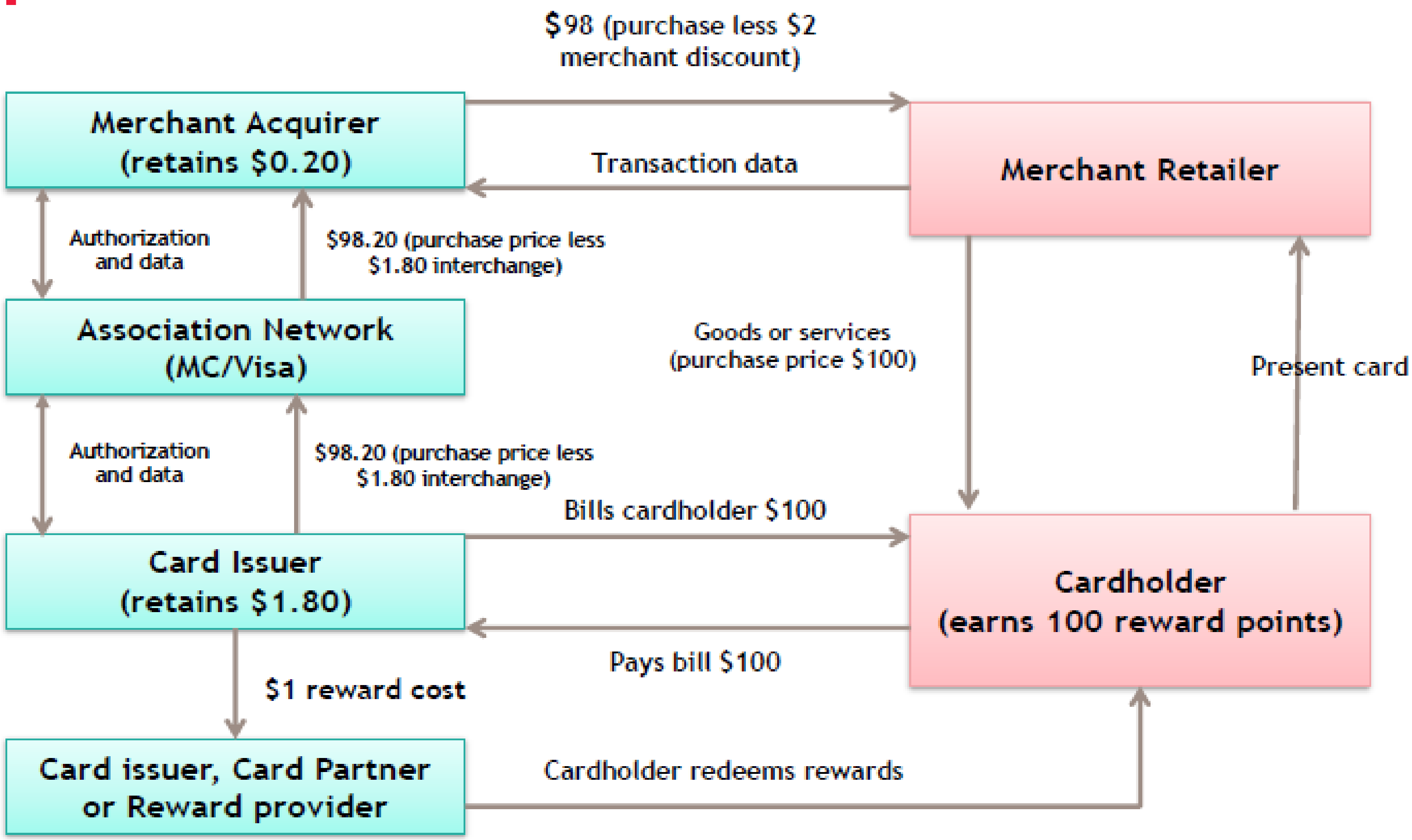
Step 1 - Financial Institutions & Specialty Finance Impact

A Credit Card arrangement is likely to be the common relationship which may have aspects that apply under the new standard. Lending relationships in which a customer borrows money and pays interest to the bank is not governed by the new revenue standard, and therefore the primary interest bearing interest relationship between a cardholder and the bank will not apply.

Each credit card transaction has two primary parties, the bank issuing the credit card and the merchant who has contracted with a separate bank to accept credit card payments (Merchant Acquiring Bank).

The next slide illustrates the flow of the transaction:

Step 1 - Financial Institutions & Specialty Finance Impact



Step 1 - Financial Institutions & Specialty Finance Impact

Due to the relationship between the merchant bank and the card issuing bank creating a separate fee for service, interchange, the parties may be deemed to have a separate contract in place that needs to be evaluated under ASC606.

In addition, the card issuing bank may be providing additional services including, membership, rewards, other services ancillary to the credit card loans themselves, that may create a separate contract which may fall under ASC606.

Step 2 - Identify Separate Performance Obligations

A *performance obligation* is a promise to provide goods or services (or a bundle of goods or services) that are either:

i. Distinct
ii. Homogenous, and both:
    - Each distinct good or service is a performance obligation satisfied over time (refer to Step #5), and
    - The same method would be used to measure the entity's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service to the customer (refer to Step #5).

Step 2 - Identify Separate Performance Obligations

Definition of a 'distinct' good or service

Can the customer benefit from the good or service, either on its own, or with other readily available resources?

('readily available resources' are those that the customer possess or is able to obtain from the entity or another third party)

No

Yes

Is the promise to transfer a good or service separate from the other promised goods or services in the contract? Indictors may include:

- The entity does not provide a significant service of integrating the goods and services
- A good or service does not significantly modify or customize the other goods and services
- A good or service is not highly dependent or interrelated with the other goods and services

No

The good or service is not 'distinct'

(these are then grouped into 'bundles' of goods and services that are themselves 'distinct')

Yes

The good or service is distinct

Step 2 - Financial Institutions & Specialty Finance Impact

Credit Card Arrangements –

The interest and late fee, usage fees, etc. associated with credit cards are not in the scope of the new standard.

To the extent a loyalty program or reward program is an included feature in a credit card contract, the terms of the contract must be examined to determine if the additional service falls within ASC 606.

The specific features of the credit card will determine likely treatment. Some common characteristics might be:

- Access to club/special sights
- Cash back or statement credit reward
- Online marketplace
- Airline or Hotel specific reward

Step 2 - Financial Institutions & Specialty Finance Impact

The card issuer will need to determine whether it also has a performance obligation for the rewards program. In making this determination, a bank will need to consider the form of the rewards program.

- Award credits are in the form of cash or statement credits, considered a contract with loan customer and rewards will not be considered a separate performance obligation.

- Award credits are in the form of goods or services, the delivery likely will be a separate performance obligation, and the card issuer will need to determine whether it is acting as the principal or the agent in satisfying that performance obligation.

Step 2 - Financial Institutions & Specialty Finance Impact

If the merchant is considered to be the customer, the rewards program will not be considered part of the contract with the merchant. The card issuer provides award credits to the cardholder because the cardholder is generating fee income for the card issuer by initiating transactions with the merchant. In this situation, the award credits will be viewed as a cost of the card issuer, similar to a commission paid to a sales agent.

Step 2 - Financial Institutions & Specialty Finance Impact

Credit card issuers also receive interchange from cardholder use of the card from the network (Visa/MC). This represents revenue from a source outside of the customer/financial institution contractual arrangement as it is with a third party and therefore needs separate revenue recognition consideration.

The card issuing bank has a basic contractual obligation to fund transactions by their cardholder to the merchant. The merchant receives this money at a discount, a portion of which is paid as interchange to the card issuing bank.

Step 3 - Determine the Transaction Price

The *transaction price* is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. This excludes amounts collected on behalf of third parties (e.g., sales taxes etc.).

The consideration promised in a contract with a customer can vary in terms of nature and timing, and this affects the determination of the transaction price.

Specific consideration is given to:

i. Variable consideration (including constraints on estimates of variable consideration)
ii. The existence of a significant financing component in the contract
iii. Non-cash consideration
iv. Consideration payable to a customer.

Step 3 - Financial Institutions & Specialty Finance Impact

If the merchant is the customer, the transaction price for the contract is the interchange fee. However, the portion of the annual fee that relates to other services, if any, may be included in the transaction price of a separate contract with the cardholder. If the cardholder is the customer, the transaction price includes the portion of the annual fee that relates to the rewards program or other services, if any. Consideration payable may also impact the transaction price. When a cash back reward is the only reward option available to the cardholder and the cardholder is determined to be the customer, the transaction price for the contract will be the portion of the annual fee that relates to the rewards program or other services, if any, less the cash payable to the cardholder.

Step 4 - Allocate the Transaction Price to Performance Obligations

- An entity allocates/splits the transaction price (determined in Step #3) between its performance obligations (identified in Step #2).
- The allocation is based on the relative *standalone selling prices* (the price at which an entity would sell a promised good or service separately to a customer) of each identified performance obligation.
  - If an observable price of a good or service for sales in similar circumstances and to similar customers exists, that price should be used.
  - If an observable price does not exist, the standalone selling price must be estimated, maximizing the use of observable inputs and considering all available information (e.g., market conditions, entity specific, customers). Several methods are available for estimating.
  - A residual approach may be used to estimate the standalone selling price only in certain situations.
- Discounts are allocated to either a specific performance obligation(s) or proportionately among all performance obligations, depending on circumstances.

Step 4 - Financial Institutions & Specialty Finance Impact

If the cardholder is the customer and a card issuer identifies the satisfaction of the rewards program or other services as separate performance obligations, the card issuer is required to allocate the transaction price (interchange and a portion of the annual fee) to those performance obligations.

The value of rewards may be readily determinable by evaluation of other offers for service, access, etc. or may require substantial judgment in determining the value.

Step 5 – Recognize Revenue

Revenue is recognized as/when an entity satisfies each performance obligation.

Satisfaction occurs as/when the entity transfers *control* (the ability to direct the use of and obtain substantially all of the remaining benefits from an asset, or prevent others from doing so) of the goods or services to the customer.

Revenue is recognized either:

(i) Over time, when the following criteria are met:

- The customer simultaneously receives and consumes all of the benefits provided by the entity's as the entity performs;
- The asset that is created or enhanced is controlled by the customer;
- The entity's performance does not create an asset with an alternative use to the entity AND there is an enforceable right to payment for performance completed to date.

(ii) At a point in time:

- If the criteria for recognition *over time* under ASC 606 are not met.

Step 5 - Financial Institutions & Specialty Finance Impact

Interchange is generally satisfied at a point in time. Regardless of who is the customer, the transaction price allocated to interchange likely will be recognized as revenue when the cardholder purchases the good or service from the merchant.

Other services such as access to airport clubs, travel agents, concierge services, etc. will likely be satisfied over time because the card issuer stands ready to provide those services throughout the performance period.

The transaction price related to these services will be recognized as revenue over the period the services are provided to the cardholder, generally the annual membership period. It is likely that this method is used under current standards.

Step 5 - Financial Institutions & Specialty Finance Impact

If the cardholder is identified as the customer, any performance obligation related to the rewards program will likely be satisfied at a point in time. The performance obligation may be satisfied when the cardholder redeems the award credits for a good or service, even if this amounts to a crediting of airline miles or hotel points to the customer account.

The function of these rewards programs also requires consideration of the relationship of the card issuing bank and whether they are acting as an agent or principal in the transaction.

Step 5 - Financial Institutions & Specialty Finance Impact

An entity is a principal if it controls a promised good or service before it transfers the good or service to a customer (do they have a product inventory).

If the bank determines that its performance obligation is to provide the good or service (i.e., the bank is the principal in the arrangement), the revenue recognized is the gross amount to which the entity expects to be entitled.

If the bank is acting as an agent (because its responsibility is to arrange for another party to provide the good or service), the revenue recognized is the net amount to which the entity is entitled to retain in return for its services.

Step 5 - Financial Institutions & Specialty Finance Impact

The standard provides the following indicators of when an entity is an agent:

- Another party is primarily responsible for fulfilling the contract.
- The entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping or on return.
- The entity does not have discretion in establishing prices for the other party's goods or services, and therefore, the benefit that the entity can receive from those goods or services is limited.
- The entity's consideration is in the form of a commission.
- The entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services.

No single indicator listed above is determinative of the relationship.

Step 5 - Financial Institutions & Specialty Finance Impact

If the card issuer is the principal related to the rewards obligation, the cost of fulfilling the rewards obligation will likely be presented as an expense rather than as a reduction of the revenue allocated to that obligation.

If rewards may be forfeited, entities are required to recognize any expected breakage as revenue in proportion to the pattern of rights exercised by the customer because entities will not be required to fully satisfy their performance obligations related to the breakage. Otherwise, breakage amounts will be recognized when the likelihood of the customer exercising its right becomes remote. The new standard focuses on preventing situations in which significant revenue reversal will occur.

Other Areas

Foreclosed Real Estate

Other Areas - OREO

As mentioned in the beginning, real estate transactions do have potential to change recognition guidance under the new standard.

The new guidance provides that sales of nonfinancial assets will be recognized when control of the asset transfers to the buyer. For sales of existing real estate properties, this will generally occur at a point in time.

Under ASC 360-20 the criteria for net investment by the buyer (meeting a significance threshold) and prohibitions on continuing involvement sometimes prevented a gain (or loss) on sale from being recognized at contract date.

Other Areas - OREO

The standard includes the following indicators that control of a promised asset has been transferred:

- The seller has a present right to payment for the asset.
- The buyer has legal title of the asset.
- The seller has transferred physical possession of the asset.
- The buyer has the significant risks and rewards of ownership of the asset.
- The buyer has accepted the asset.

These criteria, which are less onerous than the criteria in ASC 360-20, will often be satisfied at the closing date of most real estate sale transactions.

Management must still evaluate concerns over realization of principle and interest on any lending relationship entered into at inception to document the transaction has substance and is likely to be repaid.

Presentation and Disclosure

Presentation

Balance sheet

An entity is required to present the following items separately:

- Receivables
- Contract assets*
- Contract liabilities*

* Alternative descriptions can be used, however if so an entity must provide sufficient information to distinguish 'receivable' from the name given to contract assets. This is because receivables represent an unconditional right to receive consideration, whereas contract assets represent a right to consideration in exchange for providing additional goods or services.

Income statement and other comprehensive income

- An entity presents revenue from contracts with customers separately from other revenue streams.
- Impairment on both receivables and contract assets is presented separately.

Disclosure

Qualitative and quantitative disclosures include:

i. The entity's contracts with customers
   - Disaggregation of revenue
   - Information about an entity's contract assets and contract liabilities (including reconciliations)
   - Information about the entity's performance obligations
   - The entity's remaining performance obligations at the end of the reporting period.

ii. Significant judgments in the application of the guidance
   - Determining the timing of satisfaction of performance obligations
   - Determining the transaction price and amounts allocated to performance obligations

iii. Assets recognized from the costs to obtain or fulfill a contract with a customer

iv. Use of practical expedients.

BDO

Presentation & Disclosure - Financial Institutions & Specialty Finance

The level of disclosure will be dependent upon how material the credit card interchange transactions are along with the significant of any reward program included.

The general disaggregation by loan types and other sources of fee revenue should provide sufficient information in the current disclosure formats to meet the obligations for material revenue streams.

Overall the revenue disclosures are not likely to include substantial additional information.

Financial Institutions:
Income Statement

- Interest Income
  - Loans
  - Investments
  - Other (e.g., fed funds sold)
- Noninterest Income
  - Service charges and fees
  - Earnings on bank owned life insurance (BOLI)
  - Mortgage banking operations
  - Loan servicing fees
- Interest Expense
  - Deposits
  - Borrowings
- Noninterest Expense
  - Other real estate owned (OREO) charges
  - FDIC insurance

Interest income		
Loans, including fees	$	54,549
Securities		1,874
Federal funds sold		853
Total interest income		57,276
Interest Expense		
Deposits		5,721
Other borrowings		4,093
Total interest expense		9,814
Net interest income		47,462
Provision (credit) for loan losses		(7,100)
Net interest income after provision (credit) for loan losses		54,562
Noninterest income		
Service charges and fees		3,323
Earnings on bank owned life insurance		2,050
Mortgage banking operations		2,882
Loan servicing fees		2,389
Net gains on sales of securities		2,080
Other		2,904
Total noninterest income		15,628
Noninterest expense		
Salaries and benefits		22,986
Occupancy of premises		4,815
Furniture and equipment		3,259
FDIC assessment		2,196
Losses on foreclosed (OREO) properties		5,795
Admin./disp. of problem assets		5,165
Other		9,067
Total noninterest expense		53,283
Income before income tax expense		16,907
Income tax expense		5,917
Net income	$	10,990

Implementation

Implementation Plan

- Ensure staff is fully trained on new guidance
- Evaluation of changes from current GAAP to new guidance
- Determine how you plan to adopt the standard
- Determine how to track differences in periods that may need to be restated
- Identify IT system changes required to capture information needed
- Evaluate disclosures needed

Revenue Recognition Policy

- Need comprehensive revenue recognition policy(ies). For banks, these policies are typically included with the accounting policies of the corresponding asset (e.g., lending policy, investment policy)

It should address

- All material sources of revenue
- Conditions, contingencies, or circumstances that would impact the timing and amount of revenue recognition
- Accounting policy with sufficient precision (it should be **more** descriptive than what is disclosed in the financial statements)

Policy should be updated on a regular basis to reflect

- New types of transactions
- Updated accounting guidance

Questions