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ACCOUNTING UPDATE

Presented by Paul J. Nockels

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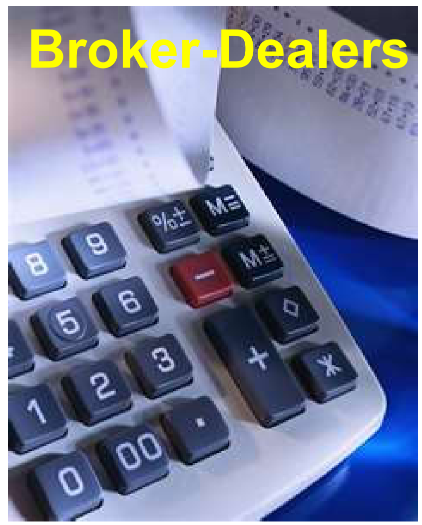
Broker-Dealer Accounting

PCAOB
Public Company Accounting Oversight Board



FINRA
Financial Industry Regulatory Authority

IFRS

FINANCIAL ACCOUNTING FOUNDATION

Private Company Council

Exchanges

Definition of a Public Business Entity

A ***public business entity*** is a business entity meeting the following criteria:

- It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- Broker-dealers are public business entities as they meet the above definition
  - Other entities meet the definition under separate criteria

Accounting Topics

- Revenue Recognition
- Leases
- Digital Currencies
- Income Taxes
- Current Expected Credit Loss (CECL)
- Derivative Financial Instruments

REVENUE RECOGNITION

Effective Date of ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*

Effective Date		
	As issued	As updated
Public entities	Annual reporting periods beginning after December 15, 2016, and the interim periods within that year	Annual reporting periods beginning after December 15, 2017, and the interim periods within that year
Example: Calendar year end	*Quarter and year beginning January 1, 2017*	*Quarter and year beginning January 1, 2018*
Nonpublic entities	Annual reporting periods beginning after December 15, 2017, and the interim periods within annual periods beginning after December 15, 2018	Annual reporting periods beginning after December 15, 2018, and the interim periods within annual periods beginning after December 15, 2019
Example: Calendar year end	*Year ending December 31, 2018 and interim periods in 2019*	*Year ending December 31, 2019 and interim periods in 2020*

Revenue Recognition Standard

- Eliminates industry specific revenue recognition
- Entity should 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.

Revenue Recognition Standard

- Entity should apply the following steps:
  1. Identify the contract(s) with a customer
  2. Identify the performance obligations in the contract
  3. Determine the transaction price
  4. Allocate the transaction price to the performance obligation in the contract
  5. Recognize revenue when (or as) the entity satisfies a performance obligation

ASC 606 Practice Challenges

- Variety in application of accounting and disclosures
  - Disaggregated revenue
  - Contract assets, contract liabilities and receivables at beginning and end of period
  - Significant judgments
  - PBE vs. non-PBE disclosure requirements
  - Early adoption by non-PBEs with PBE subsidiaries
  - Services to affiliates – contracts with customers?

LEASES

Effective date

Public business entities

- Annual and interim periods in fiscal years beginning after 12/15/2018
- Early adoption permitted
- Modified retrospective transition
  - Certain reliefs

Nonpublic business entities

- Fiscal years beginning after 12/15/2019
- Interim periods in fiscal years beginning after 12/15/2020
- Early adoption permitted
- Modified retrospective transition
  - Certain reliefs

Leases

- Upon its effective date, FASB Update 2016-02, *Leases*, will require a lessee to recognize on its balance sheet assets and liabilities for all leases other than those that meet the definition of short-term leases.

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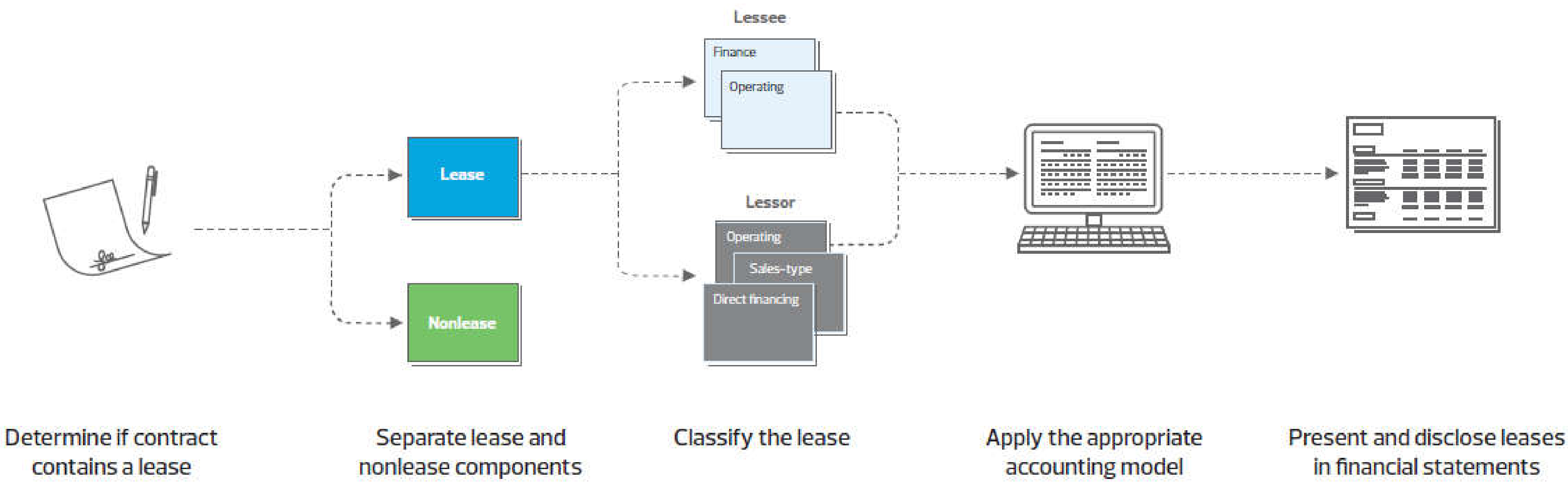
Leases overview



Treatment of Operating Leases under SEC Rule 15c3-1

- In a letter to SIFMA dated November 8, 2016 (reissued with technical improvements October 23, 2018), the staff of the Division of Trading and Markets stated it would not recommend enforcement action if a broker-dealer computing net capital adds back an operating lease asset to the extent of the associated operating lease liability.
  - Most broker-dealers reported as allowable portion of fixed assets rather than as an add back.

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Treatment of Operating Leases under SEC Rule 15c3-1

- Further, the Division will not recommend enforcement action to the SEC if a broker-dealer determining its minimum net capital requirement using the AI standard does not include in its aggregate indebtedness an operating lease liability to the extent of the associated operating lease asset.

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Treatment of Operating Leases pursuant to Rule 1.17 under the Commodity Exchange Act

- In a letter to SIFMA, the FIA, and the NIBA, dated August 13, 2018, the staff of the CFTC stated it would not recommend enforcement action if a futures commission merchant computing net capital adds back an operating lease asset to the extent of the associated operating lease liability.

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Related Party Leases

- No distinction between leases with related parties vs. third parties
- Application of Step 1 – determine if contract contains a lease
  - Included in expense sharing agreements and/or other service agreements?
  - What are the protective rights afforded to the lessee of the leased assets, if any?

Other ASC 842 Practice Challenges

- Determining the inventory of leases subject to ASC 842
- Determining the implied borrowing rate (particularly for PBEs without borrowings)

Lessee disclosures

Extensive qualitative and quantitative disclosures

Type	Example disclosures
Qualitative	• Nature of leases • Leases that have not yet commenced • Variable payment arrangements • Termination/purchase/renewal options
Quantitative	• Amortization and interest for finance leases • Operating lease cost • Variable lease cost • Short-term lease cost • Maturity analysis of lease liabilities
Significant judgments and assumptions	• Determining if a lease exists • Standalone prices

Lessor disclosures

Extensive qualitative and quantitative disclosures

Type	Example disclosures
Qualitative	• Nature of leases • Variable payment arrangements • Termination/purchase/renewal options • Information about management of residual asset risk
Quantitative	• Lease income (in tabular format) • Maturity analysis of undiscounted cash flows (segregated by finance/operating lease)

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ASU 2018-11—Leases (Topic 842): Targeted Improvements

Current	Amended
Transition—Comparative reporting at adoption	
Under ASU 2016-02, entities currently are required to adopt the new leases standard using a modified retrospective transition method. Under that transition method, an entity initially applies the new leases standard (subject to specific transition requirements and optional practical expedients) at the beginning of the earliest period presented in the financial statements.	Entities are allowed to initially apply the new leases standard at the adoption date (such as Jan. 1, 2019, for calendar-year-end public business entities) and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption.

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ASU 2018-11—Leases (Topic 842): Targeted Improvements (cont.)

Current	Amended
Separating components of a contract	
Per ASU 2016-02, an entity must separate lease components from nonlease components. Lessees are provided with a practical expedient, by class of underlying asset, to not separate nonlease components from the lease component. Under the election the entity accounts for the nonlease and lease components as a single lease component. No similar practical expedient exists for lessors.	Provide lessors with a practical expedient, by class of underlying asset, to not separate nonlease components from the associated lease component. The lessor practical expedient is limited to circumstances in which the nonlease component or components otherwise would be accounted for under the new revenue guidance and both (1) the timing and pattern of transfer are the same for the nonlease component(s) and associated lease component and (2) the lease component, if accounted for separately, would be classified as an operating lease.

ASU 2019-01—Leases (Topic 842): Codification Improvements

ASC 842	Amended
Transition Disclosures Related to ASC 250, Accounting Changes and Error Corrections	
ASC 842 requires an entity to provide transition disclosures under ASC 250 upon adoption of ASC 842, except for ASC 250-10-50-1(b)(2). That would have required an entity to disclose the effect of the change on the following items: 1. Income from continuing operations 2. Net income 3. Any other affected line item 4. Any affected per-share amounts. However, ASC 842 did not explicitly exempt entities from applying ASC 250-10-50-3, which requires the identical disclosures for interim periods after adoption	The amendments clarify the Board's original intent by explicitly providing an exception to the ASC 250-10-50-3 interim disclosure requirements in the ASC 842 transition disclosure requirements

DIGITAL CURRENCIES

Accounting and Financial Reporting of Digital Currencies

- Currently no authoritative literature under US GAAP that specifically addresses resulting in diversity in practice
- What is it?
  - Cash? Financial Instrument? Intangible? Inventory?
  - Security? Commodity? Something New?
- Why is it?
  - ICOs? Trading? Liquid Asset? Economics consideration?

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Accounting and Financial Reporting of Digital Currencies

- Recognition and measurement
  - Trade/execution date?
  - Time of day? Close of business?
  - Offsetting considerations
  - Carrying value (fair value vs. cost, subject to impairment?)
- Disclosure considerations
  - If fair value, fair value hierarchy?
  - Operating risks (keys stolen, lost, destroyed or otherwise compromised)
  - Market risks
  - Liquidity risks
  - Counterparty and credit risks – cryptocurrency platforms/exchanges

Digital Currencies – Recent Developments

- AICPA Working Groups on Accounting and Auditing Considerations
  - Working on guidance papers
- Some disagreement on whether digital currencies should be accounted for as “intangible assets”
- Digital currency activities likely to grow
  - Large brokerage firms offering bitcoin in retail accounts later this year
  - Institutional custody being offered
  - Facebook “globalcoin” to be used for retail payments offering a 10% discount to accept it

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INCOME TAXES

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BBA Audit Rules

IRS – amended partnership audit rules for tax years beginning in 2018

- TEFRA partnership audit rules replaced by the “BBA audit rules” (Bipartisan Budget Act of 2015)
- IRS may assess the partnership for tax liabilities of its partners
- Partnership is allowed to “push” the adjustments out to its partners
- Since this is not an income tax of the partnership, this is accounted for under ASC 450 as a contingent liability rather than ASC 740 as an uncertain tax position
- If the partnership recognizes a liability, it would be recognized as an equity transaction rather than an expense

CURRENT EXPECTED CREDIT LOSS (CECL)

CECL: Not Just for Banks

- Consideration of accounting for various receivables
  - Brokerage
  - Margin loans
  - Securities lending
  - Reverse repurchase agreements
  - Employee notes
  - Related party arrangements
- Additional disclosure requirements

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Overview of the credit losses standard

- ASU 2016-13, Measurement of Credit Losses on Financial Instruments
- Creates ASC Topic 326
    - Subtopic 326-20 applies to financial assets measured at amortized cost
  - Supersedes impairment guidance in ASC 310 on receivables/loans and ASC 320 on debt securities (amongst other changes)

Effective dates of the credit losses standard

- SEC filers – fiscal years beginning after 12/15/19 (including interim periods) – **2020 for calendar year-end entities (“CYE”)**
- Public Business Entities that are not SEC filers – fiscal years beginning after 12/15/20 (including interim periods) – **2021 for CYE**
- All others – fiscal periods beginning after 12/15/20 (interim periods beginning after 12/15/21) – **2021 for CYE**
- Early adoption is permitted for fiscal years beginning after 12/15/18 – **2019 for CYE**
- Adopt through a cumulative effect adjustment to retained earnings
  - Special rules for other-than-temporary impairment (“OTTI”), purchased financial assets with a more-than-insignificant amount of credit deterioration since origination (“PCD assets”) and beneficial interests

Applicability of ASC 326-20

- The following are in-scope:
  - Financial assets measured at amortized cost (AC) including:
    - Financing receivables (loans)
    - Held to maturity debt securities
    - Receivables from revenue transactions with customers and other income
    - Reinsurance receivables
    - Receivables related to repo and securities lending agreements
  - Net investment in leases
  - Off-balance-sheet credit exposures
    - Loan commitments
    - Standby letters of credit
    - Financial guarantees/similar instruments

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Applicability of ASC 326-20

- The following are out of scope:
  - Financial assets measured at fair value (FV)
    - Available-for-sale securities
    - Other
  - Loans made to participants by defined contribution employee benefit plans
  - Policy loans receivable of an insurance entity
  - Promises to give (pledges receivable) of a not-for-profit entity
  - Loans and receivables between entities under common control

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Major provisions of ASC 326-20

- Recognize expected (rather than incurred) credit losses
  - Through allowance for recognized financial assets (including held-to-maturity ("HTM”) debt securities)
  - Through liability for off balance sheet exposures
  - Results in day 1 life of asset expected loss recognition
    - Exception: Initial allowance recorded as increase to purchase price for PCD assets (Assets that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination – “Purchased with credit deterioration”)
  - Changes in the allowance (plus and minus) are recorded immediately through credit loss expense

Major provisions of ASC 326-20

- Measure expected losses on a pool basis whenever similar risk characteristics exist
- No one method required. Some examples:
  - Discounted cash flows
  - Loss rate methods
  - Roll-rate methods
  - Probability of default methods
  - Based on an aging analysis

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Major provisions of ASC 326-20

- Consider relevant available information (internal and/or external) when estimating expected losses
- Don’t rely solely on past events – Adjust historical loss information for
  - Differences in current asset specific risk characteristics
  - Circumstances when historical info is not reflective of contractual term
  - Current conditions
  - Reasonable and supportable forecasts

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Major provisions of ASC 326-20

- When estimating losses for periods beyond reasonable and supportable forecast, revert to historical loss information
  - Input level or based on the entire estimate
  - Immediately, straight line basis or another rational and systematic basis
- Include measure of expected risk of loss even if remote
  - May reach conclusion expected credit loss is zero if justified based on historical loss info adjusted for current conditions and reasonable and supportable forecasts

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Major provisions of ASC 326-20

- Collateral dependent practical expedient (PE) available when:
  - Borrower is experiencing financial difficulty
  - Repayment is expected substantially through the operation or sale of the collateral
- Base estimate of credit loss on amortized cost less fair value of collateral
  - Adjust for selling costs if expect repayment through sale of collateral
- Must be used if foreclosure is probable

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Major provisions of ASC 326-20

- Collateral maintenance provisions PE
  - Borrower required to continually adjust the amount of collateral as a result of fair value changes in the collateral
  - Limit allowance to excess of amortized cost of asset over fair value of collateral
- Through PEs only, could conclude expected loss is zero solely on the basis of the current collateral value. Absent PE, would need to consider potential future changes in collateral value and historical loss info for assets with similar collateral

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ASU 2019-05 – Targeted Transition Relief

- Provides irrevocable fair value option election for existing assets within the scope of ASC 326-20 upon its adoption
  - Election can be made on instrument by instrument basis
  - Assets need to be eligible for fair value option under ASC 825-10
  - Election not permitted for HTM securities

FINANCIAL INSTRUMENTS

ASU 2018-03, Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10)

The amendments clarify certain aspects of the guidance issued in ASU 2016-01

Issue	**Summary of amendment**
<u>Equity Securities without a Readily Determinable Fair Value – Discontinuation</u>: Once an entity elects the measurement alternative in ASC 321-10-35-2, the entity must continue to apply the alternative until the investment has a readily determinable fair value or becomes eligible for the net asset value practical expedient. *Are there additional situations that may allow for an entity to discontinue the measurement alternative?*	An entity measuring an equity security using the measurement alternative may change its measurement approach to a fair value method, through an irrevocable election that would apply to that security and all identical or similar investments of the same issuer.

ASU 2018-16—Derivatives and Hedging (Topic 815): Inclusion of the SOFR OIS Rate as a Benchmark Interest Rate for Hedge Accounting Purposes

- Previously, eligible benchmark interest rates under ASC 815 in the U.S. were US Treasury, the LIBOR swap rate, the OIS rate based on the Fed Funds Effective Rate, and the SIFMA Municipal Swap Rate
- The ASU adds the OIS rate based on SOFR as a fifth U.S. benchmark interest rate for hedge accounting purposes

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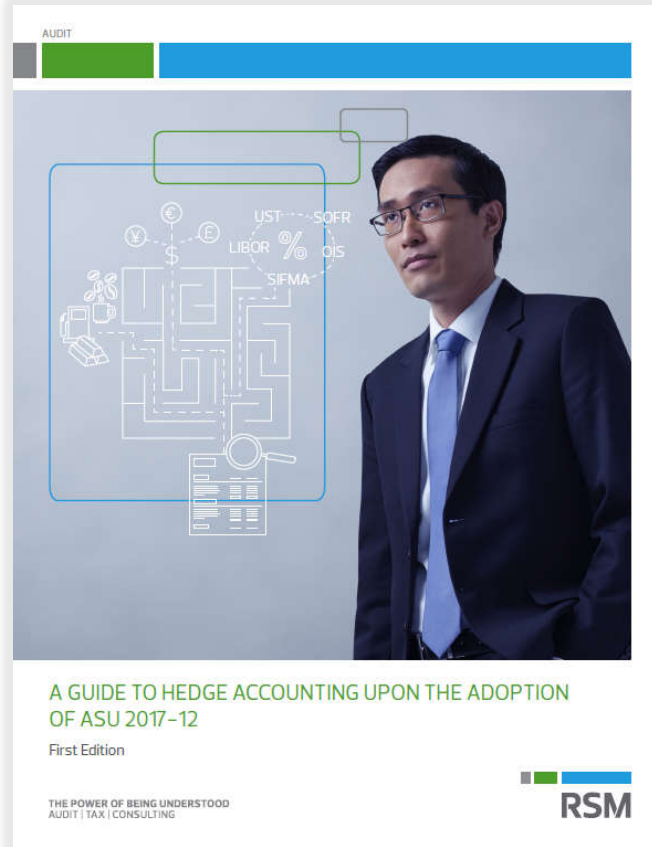
A guide to hedge accounting upon the adoption of ASU 2017-12

- This guide provides a high-level overview of hedge accounting under ASC 815, as amended by ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*. The guide includes the following:
  - Overview of hedge accounting and the requirements to apply it
  - Commodities hedging
  - Hedges related to interest rate risk
  - Foreign currency hedges
  - Fair value hedge accounting
  - Cash flow hedge accounting
- The guide also includes a high-level overview of the changes brought about by ASU 2017-12 and its transition provisions



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Resources

- AICPA Expert Panel - Stockbrokerage and Investment Banking website (Minutes)
- FASB Website (fasb.org)
- FINRA - Annual Regulatory and Examination Priorities Letter
- SEC Examination Priorities
- RSM Financial Reporting Resource Center

RSM Financial Reporting Resource Center

visit - rsmus.com/frrc

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QUESTIONS AND ANSWERS?

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