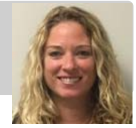
FEI
CORPORATE FINANCIAL REPORTING INSIGHTS CONFERENCE
NOVEMBER 11, 2019
DEEP DIVE: LEASES, LIBOR, AND OTHER HOT TOPICS

Moderator:
Amanda Shepherd, CPA
Executive Director, Accounting Continuing Education
Kaplan Financial Education

Speaker:
David Fabricant
Deputy Controller
American Express

AMANDA SHEPHERD



Amanda D. Shepherd, licensed as a CPA in Virginia and Florida, is the Executive Director of Kaplan's Accounting Continuing Education product line, which has been in business for over 35 years providing online and live accounting CPE training. Amanda started her CPA career in public practice as an auditor at Deloitte, gained industry experience in corporate accounting, then spent over 10 years in technical accounting at Fortune 300+ public corporations. Her technical accounting roles focused on researching and implementing new accounting standards, providing technical accounting consulting on complex transactions, developing and writing accounting policies, and developing and delivering customized technical accounting trainings within those companies. Amanda has also spoken at other organizations' conference events. Amanda graduated summa cum laude with a Bachelors of Science in Accounting at Virginia Commonwealth University.

DAVID FABRICANT

David Fabricant is the Senior Vice President & Head of Global Record to Report within the Controllership organization in American Express. He is in charge of a team of over 1000 professionals globally who are responsible for SEC Reporting and Bank Holding Company/Bank Regulatory filings, SOX Compliance and SEC's requirements for Internal Control over Financial Reporting, and overseeing Controllership's global financial operations covering financial accounting, operational accounting, oracle general ledger and balance sheet reconciliations.

Mr. Fabricant brings to American Express over 20 years of domestic and international controllership experience, with the prior 15 years dedicated to financial services. He has led the accounting, preparation, consolidation and analysis of financial statements, technical accounting implementations, securitizations, global acquisitions and divestitures as well as internal audit. In addition, Mr. Fabricant seeks continual improvement by driving efficiency and productivity through process improvements and financial management systems. Mr. Fabricant is a strategic leader that focuses on talent management.

Mr. Fabricant joined American Express in February 2011 from American International Group, Inc. (AIG), where he has served in a number of senior leadership roles since 2006, including SVP & CFO of AIG Consumer Finance Group (since October 2009); VP & CFO, Asia Pacific – AIG Consumer Finance Group, Inc. (2008 – 2009); and VP and Controller, AIG Consumer Finance Group (2006 – 2008). Prior to his tenure with AIG, Mr. Fabricant held senior level roles with Citigroup including SVP & Controller for CitiFinancial Mortgage Company Inc. (2004 – 2006) and VP Accounting Operations & Controller for CitiCards North America (1999 – 2004).

Mr. Fabricant earned a Bachelor of Science, Accounting & Finance, from Stephen F. Austin State University in Nacogdoches, Texas. He is a Certified Public Accountant.

TOPICS

1. Leases – From the Lessee Perspective
2. LIBOR
3. Other Hot Topics:
   - Topic 606
   - Non-GAAP Performance Measurements
   - SEC Comment Letters
   - Income Tax Disclosures
   - Debt Classification – Current vs. Non-Current

LEASES (TOPIC 842)
FROM THE LESSEE PERSPECTIVE

Significant Differences Between Topic 842 and Topic 840

1. Definition of a lease – control vs. use
2. Commencement date vs. inception date
3. Balance sheet impact
4. Lease classification – no bright lines
5. Lease vs. non-lease components

Topic 842

- More principles based
- Finance lease – The lease contract effectively reflects a purchase of the underlying asset – normally equipment
- Operating lease – The lease contract reflects the rental of the underlying asset – normally property
- A lessee will recognize a liability to make lease payments and a right-of-use (RoU) asset representing its right to use the leased asset for the lease term
  - Concept of control – transferring asset to the lessee
- The lessee has an accounting policy option to recognize payments on a short-term lease on a straight-line basis over the lease term, and the leases are not reflected on the balance sheet

LEASES

Implementation Challenges

- Operational Complexity
  a) Many companies have decentralized lease processes making lease identification difficult
  b) Developing and managing a data collection process to identify existing leases and future leases is time consuming and potentially costly
  c) Extraction of key data from lease agreements in a timely manner for ASC 842 will be a burden to existing processes
  d) Insert Finance early in the Contract Lifecycle Management process

LEASES

Implementation Challenges (cont.)

- System Limitations and Challenges
  a) Modifying existing lease software (leasing administration) for ASC 842
  b) 3rd party software not fully automated to meet accounting and reporting requirements
  c) System upgrades and associated testing requirements
  d) Avoid customizing and work directly with the vendor on issue resolution

Leases

Implementation Challenges (cont.)

- Embedded leases in service contracts (mainly IT contracts)
- 'Practical Expedient' election and reassessment post implementation
- Update internal controls related to leasing activity to comply with SOX
- Evaluate performance metrics going forward to determine impact on EBITDA, returns on assets, debt to equity, etc.

Leases

Implementation Challenges (cont.)

- Loan covenants and other longer term credit arrangements may be violated based on the addition of RoU assets and lease payment liabilities on the statement of financial position
- Reconsider lease vs. buy decisions as lease assets and lease liabilities are no longer off-balance sheet

LIBOR

LIBOR

- LIBOR (London Interbank Offered Rate)
- Is frequently referenced as a benchmark in loans, debt instruments, leases, and swap derivatives
- LIBOR has been recently criticized because of manipulation by financial firms as some misstated their LIBOR submissions, in collusion with each other, to make better returns on their swap records

LIBOR

- As a result, there has been a coordinated global effort to address LIBOR issues by creating more reliable alternatives
- LIBOR is expected to be phased out by the end of 2021
- From an accounting perspective, certain operational challenges may result due to needed contract modifications and hedge accounting due to this reference rate reform
  - Will these be new contracts or the continuation of existing contracts? Extinguishment vs. modifications

LIBOR

FASB Proposal – *Facilitation of the Effects of Reference Rate Reform on Financial Reporting* – Topic 848

- This proposed ASU would provide optional expedients and exceptions for applying GAAP to contracts, hedging relationships, and other transactions affected by reference rate reform if certain criteria are met
- This proposed ASU would only apply to contracts and hedging relationships that reference LIBOR or any other reference rate expected to be discontinued due to reference rate reform

LIBOR

FASB Proposal – *Facilitation of the Effects of Reference Rate Reform on Financial Reporting* – Topic 848 (cont.)

Criteria:

- The contract references LIBOR or another reference interest rate that is expected to be discontinued
- The modified terms change, or have the potential to change, the amount and timing of contractual cash flows and would directly replace or have the potential to replace a reference rate that is expected to be discontinued
- Any contemporaneous changes to other terms must be related to the replacement of the reference rate

LIBOR

FASB Proposal – *Facilitation of the Effects of Reference Rate Reform on Financial Reporting* – Topic 848 (cont.)

- This proposal would simplify the accounting evaluation of a contract modification and allow for that modification to be considered a continuation of the existing contract for accounting purposes
- This accounting relief could be applied to loans, debts, leases, or any other type of contracts affected by reference rate reform

LIBOR

<u>FASB Proposal – *Facilitation of the Effects of Reference Rate Reform on Financial Reporting* – Topic 848 (cont.)</u>

Specialized hedge accounting issues:

- The proposal would also simplify the assessment of hedge effectiveness and allow hedging relationships affected by reference rate reform to continue
- Application of this relief would be optional on a hedge-by-hedge basis

LIBOR READINESS

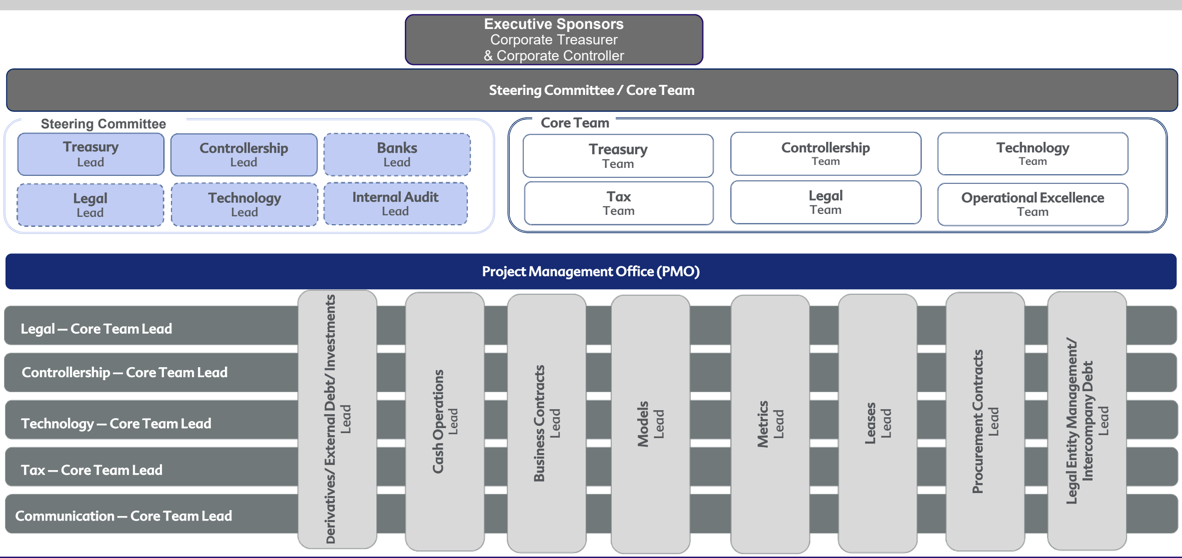
- Establish the right team to lead the transition. We have Treasury and Controllership leading this initiative
- Conduct an enterprise-wide LIBOR exposure assessment including: contracts, systems, models, etc.
- Identify, categorize, and risk assess exposure areas
  - Develop project plans for exposure remediation and implementation
  - Consider internal resource requirements and/or use of external consultants

LIBOR Readiness

Leverage the ARCC (Alternate Reference Rates Committee) Transition Implementation Checklist – ARRC Checklist

1. Establish Program Governance	6. Risk Management
2. Develop Transition Management Program	7. Assess Contractual Remediation Impact and Design Plan
3. Implement Communication Strategy	8. Develop Operational &Technology Readiness Plan
4. Identify and Validate Exposure	9. Accounting and Reporting
5. Develop Product Strategy	10.Taxation and Regulation

Governance Structure – Example



LIBOR Readiness

Early Learnings and Observations

- People and technology – ensure additional resources and work with 3rd party vendors on required system changes
- Identify contracts where LIBOR could be replaced with alternate rates like Prime/U.S. Treasury, etc.
- Leverage work done for Rev Rec and Lease implementation
- Market acceptance of alternate rate still uncertain. Difficult to design and build systems when LIBOR replacement rate is still uncertain

Accenture Industry Survey Results

- ❑ 84% of financial services firms report formal IBOR transition plan with 18% describing plan as "mature"
- ❑ 47% are not confident they understand the regulatory expectations across jurisdictions, with 21% reporting no contact with regulators around IBOR transition
- ❑ Project spending in the next 3 years is focused on legal & contractual in 2020 and operational readiness and risk management in 2021

Top 5 Areas of Focus		
2019-2021	2020	2021
Legal & Contractual	Legal & Contractual	Operational Readiness
Risk Management	Portfolio & Product Strategy	Risk Management
Operational Readiness	Accounting & Tax	Cross Industry Testing
Clients	Clients	Legal & Contractual
Governance	Valuation & Exposure Mgmt	Clients

Source: *Accenture August 2019 LIBOR Survey, which interviewed 177 firms including investment banks, commercial and retail banks, corporates, asset managers and insurance companies.*

Other Hot Topics

Other Hot Topics

- Topic 606 – *Revenue from Contracts with Customers* – Disclosures
- Non-GAAP Performance Measurements
- SEC Comment Letter Areas of Emphasis
- Proposal – Income Tax Disclosures
- Proposal – Debt Classification (Current vs. Non-Current)

TOPIC 606, *REVENUE FROM CONTRACTS WITH CUSTOMERS*

Disclosures

- Revenue recognized from contracts with customers, including the disaggregation of revenue into relevant categories
- Contract balances, including the opening and closing balances of receivables, contract assets, and contract liabilities
- Performance obligations, including when the reporting entity typically satisfies its performance obligations and the transaction price that is allocated to the remaining performance obligations in a contract
- Significant judgments, and changes in judgments, made in applying the requirements to those contracts

TOPIC 606, *REVENUE FROM CONTRACTS WITH CUSTOMERS*

SEC Comments

Disaggregation of Revenue:

- Registrants should clarify how types of categories were determined when disaggregating revenue
- Registrants should ensure that revenue disaggregated in information outside of financial statements is consistent with that disclosed in the financial statements
- Registrants should provide disaggregated revenue disclosures by type of customer specifically when discussing the timing of revenue recognition

TOPIC 606, *REVENUE FROM CONTRACTS WITH CUSTOMERS*

SEC Comments

Contract Balances:

- Primary SEC issue is concerned with disclosures about how contract balances were derived in the areas of timing of the satisfaction of performance obligations, use of customer incentives, and shipments in transit affecting contract assets and contract liabilities

TOPIC 606, *REVENUE FROM CONTRACTS WITH CUSTOMERS*

SEC Comments

Performance Obligations:

- Registrants should more clearly describe how they determined that revenue should be recognized over time or at a point in time and what judgments were made to make this determination
- Registrants should describe payment terms used when consideration is variable and if any variable consideration is constrained

TOPIC 606, *REVENUE FROM CONTRACTS WITH CUSTOMERS*

SEC Comments

Performance Obligations (cont.):

- Registrants should describe and better clarify the conclusions they reached that revenue from contracts with customers did/did not have a financing component
- Registrants should better describe the decisions made to determine if revenue should be recognized on a gross or net basis (principal vs. agent) and the judgments made to reach this conclusion

TOPIC 606, *REVENUE FROM CONTRACTS WITH CUSTOMERS*

SEC Comments

Significant Judgments:

- Registrants should more clearly identify the methods and judgments used to identify distinct performance obligations
- Registrants should describe how the determination of the transaction price was determined and the extent of any variable consideration in revenue

TOPIC 606, *REVENUE FROM CONTRACTS WITH CUSTOMERS*

SEC Comments

Significant Judgments (cont.):

- Registrants should expand their disclosures concerning the judgments made when allocating the transaction price to the performance obligations in the contract considering the methods, inputs, and assumptions made
- Registrants should disclose how they determined the standalone selling price for a good or service when allocation of the transaction price is necessary
- Registrants are reminded that step five of the revenue recognition model, recognizing revenue when (or as) the entity satisfies a performance obligation, requires that the methods used to measure when the customer has taken control of the good or service should be described in the notes

NON-GAAP PERFORMANCE MEASUREMENTS

- Managements often believe that GAAP financial reporting outcomes do not reflect the correct results of operations for the business
- Non-GAAP performance measures are used by managements to tell the company's story by providing insights as to how management is evaluating the operating performance and liquidity of the company from its internal reporting perspective
- This is often done by eliminating non-recurring charges and other activities that they believe are outside the scope of ongoing recurring operations

Non-GAAP Performance Measurements

Examples of non-GAAP performance measurements include:

- Adjusted operating income
- Adjusted revenue or adjusted earnings
- Core earnings
- Contribution margin
- Free cash flow
- EBIT
- EBITDA

Non-GAAP Performance Measurements

According to PWC

- 1996 – 59% of the S&P 500 used at least one non-GAAP measurement
- 2016 – 76% of the S&P 500 used at least one non-GAAP measurement
- 2018 – 97% of the S&P 500 used at least on non-GAAP measurement

NON-GAAP PERFORMANCE MEASUREMENTS

- The SEC has established regulations on the use of non-GAAP performance measurements primarily in Regulation G, Item 2.02 of Form 8-K, and Item 10(e) from Regulation S-K
- These regulations generally require:
  - The disclosure of the use of non-GAAP measurements, the reasons why they are used
  - Requires that the non-GAAP measurements cannot be more prominently displayed than the equivalent GAAP measurements
  - That a reconciliation of the differences between the non-GAAP measurement and the most directly-comparable GAAP financial measurement

NON-GAAP PERFORMANCE MEASUREMENTS

- FASB has started to acknowledge the relevance of non-GAAP measurements and has created a project to begin studying their usefulness
  - *Financial Performance Reporting—Disaggregation of Performance Information*
- Basically, FASB and the SEC are evaluating whether certain non-GAAP performance measurements provide a better “fair presentation” than traditional GAAP measurements

SEC Comment Letter Areas of Emphasis

Annual Period Ending 6/30/2019

1. Revenue Recognition – Topic 606
2. Non-GAAP Measurements – Disclosure of
3. Fair Value Measurement – Valuation methods
4. MD&A – Critical accounting estimates and drivers of cash flows
5. Business Combinations – Purchase price allocations
6. Goodwill and Other Intangibles – Impairment assessments
7. Segment Reporting – Identification of operating segments
8. Income Taxes – Effective tax rates and valuation allowances

FASB Proposal for Changes to the Disclosure Requirements for Income Taxes

- Part of FASB's Disclosure Framework Project
- Designed to improve the effectiveness of tax disclosures in the financial statements
- Scope applies to reporting entities required to apply Topic 740, *Income Taxes*

FASB Proposal for Changes to the Disclosure Requirements for Income Taxes

<u>Objectives – Provide Users with Information about the Following</u>

- An explanation of how income taxes affect financial statement line items and assumptions that a reporting entity makes in determining those line items
- The income tax components of different jurisdictions, tax issues, or scheduled expiration dates that are measured differently or could affect prospects for net cash flows differently
- Cause of the changes in financial statement line items related to income taxes
- The difference between expectations based on statutory rates and the effective rate
- Acceptable alternative accounting policies or methods

FASB Proposal for Changes to the Disclosure Requirements for Income Taxes

In addition, this proposal would replace the term "public entity" currently used in Topic 740, *Income Taxes*, with the term "public business entity" as defined in the Master Glossary of the FASB Codification.

FASB Proposal for Changes to the Disclosure Requirements for Income Taxes

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a public business entity:

1. 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).
2. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
3. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

FASB Proposal for Changes to the Disclosure Requirements for Income Taxes

A public business entity is a business entity meeting any one of the criteria below (cont.):

4. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
5. It has one or more securities that are not subject to contractual restrictions on transfer and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

FASB Proposal for Changes to the Disclosure Requirements for Income Taxes

<u>Added Income Tax Disclosures for Public Companies</u>

1. Income (or loss) from continuing operations before income tax expense (or benefit) and before intra-entity eliminations disaggregated between federal, state, and foreign
2. Income tax expense (or benefit) from continuing operations disaggregated between federal, state, and foreign
3. Income taxes paid disaggregated between federal, state, and foreign
4. The line items in the statement of financial position in which the unrecognized tax benefits are presented and the related amounts of such unrecognized tax benefits

FASB Proposal for Changes to the Disclosure Requirements for Income Taxes

<u>Added Income Tax Disclosures for Public Companies (cont.)</u>

5. The amount and explanation of the valuation allowance recognized and/or released during the reporting period
6. A reconciliation between the amount of reported total income tax expense (or benefit) from continuing operations and the amount computed by multiplying the income (loss) from continuing operations before tax by the applicable statutory federal or national income tax rate, showing the reporting currency amount of each of the underlying causes for the difference (consistent with SEC Regulation S-X)

FASB Proposal for Changes to the Disclosure Requirements for Income Taxes

Added Income Tax Disclosures for Public Companies (cont.)

7. The amounts of deferred tax assets for federal, state, and foreign carryforwards (tax effected before any valuation allowance) by time period or expiration for each of the first five years after the reporting date, a total for any remaining years, and a total for carryforwards that do not expire
8. The total amount of unrecognized tax benefits that offsets the deferred tax assets for carryforwards
9. The amounts of any valuation allowance recognized for deferred tax assets for federal, state, and foreign carryforwards

FASB Proposal for Changes to the Disclosure Requirements for Income Taxes

Deleted Income Tax Disclosures

Eliminate the requirement for all entities to:

1. Disclose the nature and estimate of the range of the reasonably possible change in the unrecognized tax benefits balance in the next 12 months, or
2. Make a statement that an estimate of the range cannot be made

FASB Proposal for Debt Classification – Current vs. Non-Current

- Part of FASB's Simplification Initiative
- Designed to reduce cost and complexity in U.S. GAAP
- Current debt classification is overly complex
- Topic 470, *Debt*, includes guidance on various narrow-scope, fact-specific debt transactions
- Proposal replaces fact-specific examples with one cohesive principle
- Scope applies to all reporting entities that enter into debt arrangements

FASB Proposal for Debt Classification – Current vs. Non-Current

Cohesive Principle

A reporting entity should classify an instrument as non-current if either of the following criteria is met as of the balance sheet date:

1. The liability is contractually due to be settled more than one year (or operating cycle, if longer) after the balance sheet date
2. The reporting entity has a contractual right to defer settlement of the liability for at least one year (or operating cycle, if longer) after the balance sheet date

FASB Proposal for Debt Classification – Current vs. Non-Current

Cohesive Principle (cont.)

- Liabilities classified as non-current as a result of obtaining a waiver for a debt covenant violation must be classified separately in the balance sheet from other non-current liabilities
- Short-term debt refinanced after the balance sheet date would continue to be classified as current as of the balance sheet date since a subsequent refinancing occurs after the balance sheet date based on facts different than that at the balance sheet date
- Subjective acceleration clauses would only impact debt classification when they are triggered

FASB Proposal for Debt Classification – Current vs. Non-Current

Cohesive Principle – Issue to Consider

Debt classification when it is the intent of the reporting entity to settle the debt with its own equity instruments:

- According to the FASB Codification, a current liability is one where it is settled through the use of current assets or the creation of other current liabilities
- If the debt is to be settled with equity instruments, must the debt always be classified as non-current?

CPE for Every Level of Your Organization with Accounting Continuing Education

Supported by SmartPros® and the Loscalzo Institute, our customizable programs are designed for the entire accounting and finance audience, from those who require CPE to those who could benefit from soft-skills and behavioral training, in whichever format best suits your organizational needs.

- Financial Management Network Library
- Financial Learning Library
- CPA Report Library
- CPA Government Not-for-Profit Library
- Webcasts
- NANO CPE Online Offering
- Live Public or Private Seminars

KAPLAN® FINANCIAL EDUCATION Powered by SmartPros and Loscalzo Institute