WINTER 2018
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THE NEWSLETTER OF THE BDO FINANCIAL INSTITUTIONS AND SPECIALTY FINANCE PRACTICE

FINANCIAL INSTITUTIONS IN FOCUS

CONTENTS

FINANCIAL INSTITUTIONS REVENUE RECOGNITION REMINDER CHECKLIST

By Paul Bridge and Joe LaClair

On Jan. 1, 2018, ASC Topic 606, *Revenue from Contracts with Customers*, takes effect for publicly traded organizations, and all other companies must follow suit in 2019. Issued by the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) in May 2014, the standard aims to create a more comprehensive picture of revenue recognition—comparable across industries and across countries.

Financial institutions will need to carefully evaluate all services and contracts to determine whether Topic 606 applies.

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REVENUE RECOGNITION

REMINDER CHECKLIST

This document is intended to be used as a reminder of ASC 606 requirements and other reporting considerations, but it is not intended to be a complete checklist. Rather, judgment will be required in order to consider specific circumstances regarding requirements for ASC 606 assessments. Any "no" responses should generally prompt additional consideration.

Considerations	Yes	No	N/A	Comments
Does the ASC 606 assessment clearly identify the material revenue streams scoped in and scoped out of ASC 606, and the basis for such conclusions?				
Have immaterial revenue streams been evaluated in the aggregate to determine if they are material when aggregated?				
For transaction streams identified as scoped out, are references included regarding the applicable ASC Topics which address those transactions?				
The Assessment should include the following: ▶ Method of adoption ▶ Address net vs. gross presentation ▶ Include the ASC 606 disclosures ▶ Disclosures presented in accordance with ASC 606-50				
Do revenue streams exist that are partially governed by ASC 606 and partially by another ASC Topic?				
If partially impacted revenue streams exist, (in other words, another standard specifies how revenue recognition is recognized, but aspects of that revenue are not covered by that topic/standard), did the company allocate the transaction price relating to parts of the contract dealt with by other Topics and apply the requirements of the other Topics to the transaction price allocated AND apply the requirements of Topic 606 to the transaction price allocated to parts of the contract not dealt with by another Topic?				
For revenue streams in scope of ASC 606, address each five-step process for every revenue stream **and for each distinct contract**: Step 1: Identify the Contract Step 2: Identify Separate Performance Obligations Step 3: Determine the Transaction Price Step 4: Allocate Transaction Price to Performance Obligations Step 5: Recognize Revenue when or as Each Performance Obligation is Satisfied				
Have internal controls over the assessment and implementation been designed, implemented and assessed for effectiveness?				
Have you considered the potential tax implications that may be triggered as a result of ASC 606 adoption, and has your organization put in place new data collection and retention policies that may be required to substantiate tax changes? Possible tax implications could include: ▶ Tax accounting method changes ▶ Book-tax differences ▶ Cash taxes ▶ ASC 740 – Deferred taxes, current/non-current taxes payable – at adoption/prospective ▶ Federal, state, indirect and foreign taxes ▶ Transfer pricing				

For additional details on how ASC 606 may apply to your organization, access our full *Financial Institutions Reminder Checklist* here.

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CURRENT EXPECTED CREDIT LOSS (CECL) STANDARD UPDATE: BEST PRACTICES FOR IMPLEMENTATION

By BDO CECL Leadership Team, in collaboration with SS&C Primatics

INTRODUCTION TO CECL

In June 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update **(ASU) No. 2016-13, Financial Instruments – Credit Losses (Topic 326)**.

The current expected credit loss (CECL) standard marks a significant shift in the way credit losses on many financial assets, especially loans, are recorded. Under the standard, the ASU requires that banks estimate and record credit losses on loans and other assets (e.g., HTM debt securities) within the scope of the CECL model based on expected loss over the contractual life of the loan (considering prepayments). The goal of the new standard is to improve investor and financial statement user access to more timely information about credit losses and likely would require banks to record losses sooner than under current GAAP.

The standard applies to all banks, savings associations, credit unions and financial institution holding companies, regardless of asset size. More details on the standard can be found **here**.

While banks have until 2020 or 2021 to implement CECL, they must plan for adoption now. Most banks do not currently collect the level of disaggregated data that will be required to calculate the life of the loan estimate and should promptly begin exploring the right measurement method and new processes for their organization. Significant judgment will be required in forecasting, and banks should begin speaking with advisors and planning immediately. Bank executives should also start educating their finance executives, investors and stakeholders about the new standard and how it will change their metrics and integrate with budgeting and planning.

CECL IMPLEMENTATION BEST PRACTICES

CECL does not require that a particular method is used to estimate expected credit losses. Institutions can leverage practical methods relevant to the circumstance[1]; actual estimation methods will range anywhere from simplistic approaches to sophisticated models. For larger institutions, the decision to leverage predictive models may be straightforward. However, smaller institutions, especially those under $10 billion, are weighing the costs and benefits of a variety of approaches. Given the range of possibilities, many are struggling with the decision.

1 Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) No. 2016-13, Financial Instruments-Credit Losses (326-20-55-7).

Read more ▶

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CURRENT EXPECTED CREDIT LOSS

A BROAD SPECTRUM OF CECL-COMPLIANT METHODS

A wide variety of methods, falling on a spectrum between a model-based and analytical approach will be considered *CECL-compliant*.

- A **model-based approach** leverages predictive models to forecast future borrower behavior based on statistical analysis of historical loss information. A modeled approach streamlines the reserving process and offers the most potential crossover use for risk management purposes. But these benefits are not without cost; the initial and ongoing investment in developing and maintaining models can be a significant barrier.
- An **analytical approach** consists of personnel using subjective judgment to arrive at the expected credit loss based on analyses performed in spreadsheets. An analytical approach requires relatively low up-front investment and is easy to implement. However, a primarily analytical approach will resemble the qualitative adjustment process under the current collective reserve, which many banks consider to be onerous due to the high level of subjective judgment and manual nature of the process.

Regardless of the method used, the same objectives must be met: relevant variables need to be identified, the relationship between the variables and losses need to be estimated, and the entire end-to-end process will be subject to Sarbanes-Oxley controls.

THE ENHANCED ANALYTICAL APPROACH

Both the model approach and the analytical approach have advantages and disadvantages but, for some banks, the answer may be somewhere in the middle. SS&C Primatics refers to this as an enhanced analytical approach. Put simply, the enhanced analytical approach combines the advantages of a modeled and analytical approach and minimizes the disadvantages of each. An enhanced analytical approach applies more rigor and consistency to the reserving process than a purely analytical approach and allows the bank to leverage current reserving processes and data. Leveraging a simple, easy to understand model reduces risk and makes model risk management significantly easier than that of a complex model.

THE FOUNDATION OF A SUCCESSFUL CECL RESERVING PROCESS

It is imperative to keep in mind that CECL preparation is more than just a temporary project. In other words, the decisions made between now and adoption (2020 for SEC filers, and 2021 for all others) will be part of a process that will continue indefinitely.

When evaluating a particular method, in addition to asking *will this be compliant*, banks should ask themselves, *how will this contribute to a successful process in the long run?* The distinction between *compliance* and *success* is an important one. CECL *compliance* means meeting the requirements in the standard. However, a successful CECL implementation is about more than just checking a box. The elements of a successful CECL reserving process will include:

- An integrated process that joins the allowance estimate with data, disclosures and analytics in a controlled, scalable and repeatable manner
- A dynamic reporting framework that conveys a cohesive narrative explaining what happened and why, period over period
- A controls framework that includes full audit trails, role-based permissions, segregation of duties and data lineage

The basis of a successful CECL transition will require much more than a CECL-compliant estimate. Success will require taking a holistic view of the end-to-end reserving process and leveraging the right tools to get the job done efficiently and effectively.

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ABOUT SS&C PRIMATICS

A BDO collaborator, SS&C Primatics solves financial institutions' most complex challenges with EVOLV, an integrated risk and finance platform. A key differentiator for 13 of the top 30 U.S. Banks, EVOLV streamlines accounting, reserving, and credit functions, enabling clients to operate more efficiently, make better business decisions, and capitalize on growth opportunities.

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FINCEN ADVISORY ON NORTH KOREA'S USE OF THE INTERNATIONAL FINANCIAL SYSTEM

By Adil Raza and Chuck Pine

On Nov. 2, 2017, the Financial Crimes Enforcement Network (FinCEN) issued an advisory[1] to further alert financial institutions to North Korean schemes being used to evade U.S. and United Nations (UN) sanctions, launder funds, and finance the North Korean regime's weapons of mass destruction (WMD) and ballistic missile programs.

The advisory was issued in conjunction with a final rule pursuant to Section 311 of the USA Patriot Act prohibiting financial institutions from opening or maintaining a correspondent account for, or on behalf of, Bank of Dandong. These actions follow the targeting, by the Department of Treasury's Office of Foreign Assets Control (OFAC), of several representatives of North Korean financial institutions on Sept. 26, 2017[2]. The advisory provides a list of red flags that will assist financial institutions in identifying and reporting suspected illicit activity involving the North Korean government and its financial institutions.

FinCEN references the UN Security Council "Report of the Panel of Experts established pursuant to resolution 1874," (February 2016) which found that North Korean state-owned enterprises typically orchestrate elaborate trade-based payment schemes involving the sale of prohibited natural resources[3], mainly to China-based companies which in turn sell these natural resources to the Asian market.

"The North Korean state-owned enterprises indirectly receive payment, from the China-based companies, through a complex layering scheme involving front companies, shell companies, shipping or trade businesses based in Asia (often registered in Hong Kong), and other companies based in various offshore jurisdictions (e.g., British Virgin Islands, Marshall Islands and the Seychelles)."

These front or shell companies are used to purchase and ship commodities, which may include goods that can be used to further the WMD and ballistic missiles programs, to North Korea.

RED FLAGS OF POTENTIAL NORTH KOREAN ILLICIT FINANCIAL ACTIVITY

FinCEN notes that many North Korean-related front companies, financial representatives and corporate service providers working on behalf of the North Korean government often share similar characteristics. Financial institutions should consider the below red flags in reviewing and assessing financial activity to ensure that their correspondent accounts are not being used to facilitate prohibited transactions and to assist in reporting potentially suspicious transactions to FinCEN.

- North Korean-born representatives often use Chinese aliases or Chinese facilitators to establish and operate bank accounts and

1 See https://www.fincen.gov/resources/statutes-and-regulations/311-special-measures
2 See https://www.treasury.gov/resource-center/sanctions/OFAC-Enforcement/Pages/20170926_33.aspx.
3 UNSCR 2371 prohibits imports of North Korean coal, iron and iron ore, lead and lead ore, and seafood. UNSCR 2375 prohibits imports of textiles, among other new measures.

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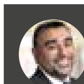
FINCEN ADVISORY

front or shell companies. They may also appear as signers for accounts maintained by the front or shell companies.

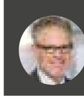
- North Korean-born representatives appearing as corporate officers of multiple, seemingly unrelated, front or shell companies that also often transact with each other.
- Use of multiple companies with the same owners or managers. These companies also frequently share addresses, telephone numbers and employees, and they may transact with similar business partners.
- Front and shell company addresses frequently recycled and used for multiple business registrations, particularly addresses in the Jiadi Square area in the city of Dandong in the Liaoning province of China, where the North Korea Dandong Consulate is also located.
- Front and shell companies registered in either the Liaoning province in China—specifically in the municipalities of Dalian, Dandong, Jinzhou and Shenyang—which border North Korea, or in Hong Kong, a major financial center with a variety of corporate service providers.
- Substantial financial activity involving front or shell companies unrelated to stated areas of business or lacking a business purpose.
- Lack of online presence despite significant financial activity.
- Correspondent account transactions conducted by, or on behalf of, Liaoning-based banks, including, but not limited to, institutions located in the cities of Dalian, Dandong, Jinzhou and Shenyang.
- Financial activity transacted through front and shell companies, often sharing the same address, occurring in cycles, whereby one company will pay a common beneficiary for a period of time and then cease payments, which will then be made through another company sharing the same address.
- Front or shell companies using shipping and import/export businesses including textile, garment, fishery and seafood businesses as well as coal and other commodity trading businesses.

ABOUT BDO'S RISK AND REGULATORY PRACTICE

BDO's Risk and Regulatory Advisory practice provides wide ranging regulatory compliance services. In particular with financial institutions, our professionals have extensive experience with advising, developing and implementing compliance programs to ensure compliance with the Bank Secrecy Act (BSA), OFAC and other federal laws and requirements. With our well-versed knowledge and expertise with BSA, anti-money laundering (AML), and OFAC regulations and pulse with regulatory trends, our professionals are well-equipped to help you meet your BSA/AML and OFAC requirements, and your organization's specific compliance needs.



Adil Raza, a senior manager in BDO's Risk and Regulatory Advisory Services practice in New York City, can be reached at araza@bdo.com.



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PErspective in FinTech

U.S.-based fintech startups have pulled in roughly $18 billion through some 1,400 deals with VC participation since the beginning of 2015, according to **PitchBook**.

THE 5 MOST HIGHLY VALUED VC-BACKED FINTECH COMPANIES IN THE U.S.:

Source: **PitchBook**

FINTECHS THAT RAISED THE LARGEST AMOUNTS OF VC FUNDING IN H1 17:

- U.S.-based **SOFI** raised **$453M** in March
- U.S.-based **AVIDXCHANGE** raised **$300M** in June
- China-based **E-LIFE FINANCIAL** raised **$275M** in January
- China-based **TUANDAIWANG** raised **$261M** in May
- India-based **PAYTM** raised **$200M** in March

Source: **Innovate Finance**

MOST ACTIVE VC INVESTORS IN FINTECH/ U.S. INVESTORS ARE LEADING THE PACK:

- U.S.-based **500 STARTUPS**
- U.K.-based **STARTUPBOOTCAMP**
- U.S.-based **Y COMBINATOR**
- U.S.-based **DIGITAL CURRENCY GROUP**
- U.S.-based **TECHSTARS**

Source: **Innovate Finance**

U.S. REGULATION: The Commodity Futures Trading Commission (CFTC) has a new initiative called LabCFTC, that will focus on better regulating fintech startups. LabCFTC will serve as a platform for international and domestic regulators to deliberate best practices.

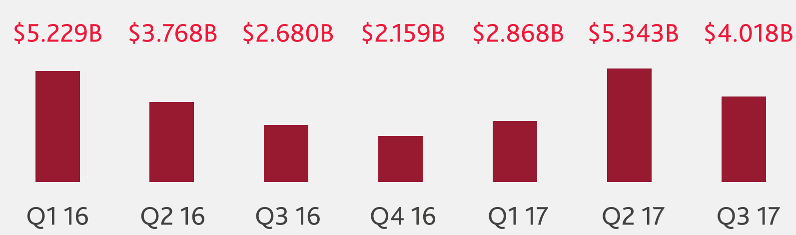
Source: http://www.cftc.gov/PressRoom/PressReleases/pr7558-17

Global VC-backed fintech companies raised a little over $4 billion in Q3 17, up from about $2.7 billion in Q3 16.

Interestingly, Q2 17 marked the highest amount ever raised in a single quarter, with more than $5.3 billion of funding.

Source: **CB Insights**

DEAL VALUE

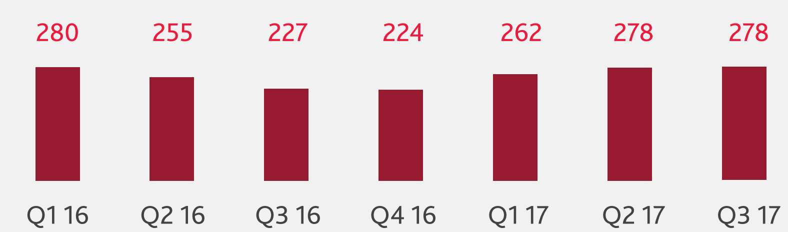


Meanwhile deal volume has continued rising, even if only slightly. In Q3 17, there were 278 fintech deals, up from 227 in Q3 16.

Deal volume, however, has stayed flat over Q2 and Q3 17.

Source: **CB Insights**

DEAL VOLUME



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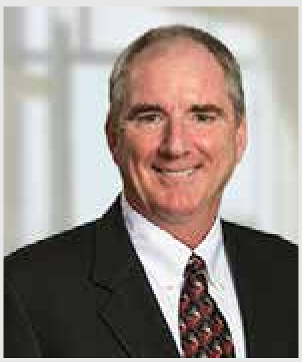
BDO SPOTLIGHT:

Q&A with Paul Bridge and Joe LaClair



Paul Bridge and **Joe LaClair** are the national co-leaders of BDO's Financial Institutions & Specialty Finance (FI-SF) practice. With more than 25 and 33 years of public accounting experience respectively, Paul and Joe provide services to public and privately held financial institutions on a variety of accounting, financial reporting and internal control matters.

Can you tell us more about your background, and what drew you to BDO?

Joe: I started my public accounting career in 1984 and worked for several regional firms throughout New York State and Pennsylvania. After working for more than 29 years at a variety of public accounting firms, I and several other partners joined BDO in June 2013. My specific experience in the financial services sector originated from working with different types of community banks at my first firm, Coopers & Lybrand, and then later at TFG in upstate New York and BMC in Pennsylvania. I've now been in community banking for more than 33 years.

Paul: My path is similar to Joe's. Prior to joining BDO in 2006, I worked for a variety of professional services firms, including Arthur Andersen, a private equity firm and a Big Four accounting firm. What really drew me to BDO was its unique structure and emphasis on openness, accessibility and transparency. We have direct access to the firm's top technical resources, and we share leading edge technical issues with our clients as they come up.

Can you share with us your vision for the practice, and what you believe to be BDO's main differentiators?

Paul: The Financial Institution and Specialty Finance practice has historically been focused on certain regions and niche markets, including community and industrial banks. We would like to expand our reach to include more national banks while continuing to serve our current client base at the highest level. Servicing middle market financial institutions is our sweet spot, and we differentiate ourselves from our peers by providing a high level of personalized services for these companies. Our DNA is centered around the way we handle and treat our clients, from the local to the national level.

Joe: That's exactly how I see it. As Paul mentioned, we plan to continue to move upstream and offer our services to markets outside of our local offices. We believe we have a unique advantage: BDO has many capabilities that most other firms don't have, including greater bandwidth to give clients the individual attention they need. We understand that as financial institutions grow, they face more oversight from the U.S. Securities and Exchange Commission (SEC), along with other regulatory bodies. Our challenge is to help clients of all sizes operate in today's highly regulated environment, without losing focus on their needs and strategic objectives.

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SPOTLIGHT

What are the biggest pain points for middle market financial institutions, and how do they differ from those of larger players?

Paul: As Joe mentioned, the regulatory environment is becoming increasingly complex. There are two big developments coming down the pipe: the Financial Accounting Standards Board (FASB)'s new revenue recognition standard and current expected credit loss (CECL) model. The former establishes principles that help companies report the nature, amount, timing and uncertainty of revenue from contracts with customers, while the latter changes the accounting for credit losses for certain instruments.

The challenge for many middle market banks is that they're expected to implement these changes with the same level of sophistication as the megabanks. A similar issue came up when the New York Department of Financial Services issued its cybersecurity regulation, which required compliance from all financial institutions equally, regardless of size. While this is a significant change for all banks, smaller banks that don't have the resources of their larger peers may feel the greatest impact.

Joe: It's becoming increasingly expensive for banks to do business, whether it's preparing for internal controls audits or keeping up with the complexity of financial reporting. One big frustration for bankers is that the oversight and implementation for many regulations tend to be very prescriptive; the burden can be very different for two similar banks. These additional compliance costs put serious pressure on margins and make it even harder for financial institutions to navigate the already low interest rate environment.

When considering these increasing compliance costs, how can banks survive?

Joe: The increase in non-operational costs over the years has led to more consolidation in the industry, as well as more pressure to scale. Many smaller banks are recognizing their inability to keep up with costs and, consequently, the need to merge with another bank or grow quickly.

Paul: Banks today have three main growth options: organically, through mergers or by looking outside the traditional banking model to acquire and adopt emerging technologies. The latter method is a work in progress, as many banks still see non-traditional models, such as Fintech, as both a threat and an opportunity. Many companies *do* want to go beyond traditional brick-and-mortar banking, and traditional banks are working hard to understand these "non-traditional" service models.

What advice would you give to your smaller and/or middle market clients?

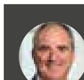
Paul: Regardless of size, all banks should stay true to their niche or customer base and focus on where they can deliver a real difference. Delivering excellent customer service should always be a top priority and includes being responsive and staying abreast of industry issues. This is especially important for community banks, where the customer base often appreciates a more hands-on approach to banking.

Joe: While the regulatory environment is constantly changing, banks do have a say in the products and services they offer and their ability to deliver. It's important they offer a variety of products and services in a one-stop shop, or their customers could seek other alternatives.

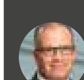
As we get closer to 2018, what should clients be thinking about when it comes to year-end planning?

Paul & Joe: Right now, our focus is on the implementation of the FASB's new revenue recognition standard, CECL and the accompanying documentation requirements. Regarding the former, Paul is the chair of the [AICPA Depository and Lending Institutions Revenue Recognition Task Force], which has documented the required considerations.

Unfortunately, many banks are lulled into a false sense of security and non-applicability when it comes to revenue recognition, as not all will directly be impacted. A poll at a recent AICPA banking conference revealed that more than 70 percent of conference participants felt they were woefully behind in preparing for the new standard, which is not a promising sign. Many financial institutions are currently more focused on CECL, which affects them more directly. Nonetheless, organizations must prepare for both or risk falling behind.



Paul Bridge, managing partner in BDO's Spokane, Wash., office and co-industry group leader of the Financial Institutions & Specialty Finance (FI-SF) practice, can be reached at pbridge@bdo.com.



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MARK YOUR CALENDAR

The following is a list of upcoming conferences and seminars of interest for financial institution executives:

JANUARY 2018

Jan. 17-19
The North American Bitcoin Conference
James L. Knight Center
Miami, Fla.

Jan. 19-26
London Blockchain Week
Grange Tower Bridge Hotel
London, U.K.

Jan. 30-31
Paris Fintech Forum
Palais Brongniart
Paris, France

FEBRUARY 2018

Feb. 5-7
Deluxe Exchange
Boca Raton Resort & Club
Boca Raton, Fla.

Feb. 16-18
The Bitcoin, Ethereum & Blockchain SuperConference
Marriott Dallas/ Fort Worth Airport
Irving, Texas

Feb. 25-28
National Conference for Community Bankers
Hilton Hawaiian Village, Waikiki Beach Resort
Honolulu, Hawaii

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BDO FINANCIAL INSTITUTIONS & SPECIALTY FINANCE PRACTICE

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