Update on CECL and Lease Accounting

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Intentions

- Enable you to understand how the new Current Expected Credit Loss (CECL) accounting rule affects your calculation and reporting of bad debt reserves
- Enable you to understand the impact of changes in operating lease accounting on the interpretation of financial statement results.

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Background

- Financial crisis of 2008
  - Outside investors left to their own means in regard to measuring anticipated credit losses
- Financial Crisis Advisory Group (FCAG)
  - FASB/IASB creation: intention to improve financial reporting in regard to financial crises
  - Conclusion: existing standards unduly delay the recognition of credit losses
  - Recommendation: create models to anticipate credit losses and adjust asset values at earlier points in time

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Accounting Standards Update (ASU) 2016-13

- Topic 326: Financial Instruments—Credit Losses
  - Measurement of Credit Losses on Financial Instruments
- "Provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. "
- "Replace the incurred loss impairment methodology in current GAAP with a methodology that reflects ***expected credit losses*** and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates."

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Who is impacted and how?

- Affects entities holding financial assets and net investment in leases that are ***not accounted for at fair value*** through net income. Includes:
  - Loans, debt securities, ***trade receivables***, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and others.
- Affects an entity to varying degrees depending on
  - Asset credit quality
  - Duration
  - How the entity applies current GAAP. There is diversity in practice in applying the incurred loss methodology, which means that ***before transition some entities may be more aligned, under current GAAP, than others to the new measure of expected credit losses.***

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Financial Statement Impact

- **Balance sheet**:
  - Financial assets measured at ***amortized cost basis***
  - Presented at the ***net amount expected to be collected***.
  - The allowance for credit losses is a ***valuation account***
    - Deducted from the cost basis to present the net carrying value at the amount expected to be collected
  - **Income Statement**:
    - Includes credit losses for newly recognized financial assets, as well as changes in expected credit losses on existing assets

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Measurement Methodology

- Based on relevant information
  - historical experience
  - current conditions
  - ***reasonable and supportable forecasts***
  - An entity ***must use judgment*** in determining the relevant information and estimation methods that are appropriate in its circumstances.
- May apply rigorous statistical analysis, but it is not required

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As applied

- Measures need to be forward looking
- Bad debt reserve is valued as credit is extended
- Bad debt reserve measured even for accounts ***NOT*** past due
- Essentially becomes a continuous process
- Methodologies may be simple: inputs must be justified
- Tailor made for robotic analytics
- Allows for a "Q-factor:" qualitative adjustments to forecasted outcomes

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Sample Methodology Using Account Aging

- Q-factor adjustment: Expected recession: Increase by 0.15%
- Expected bad debt loss: $121.00 * 0.00646 = $0.78 MM
- Amortized cost of A/R: $121.00 - $0.78 = $120.22 MM

A	B	C	D	E
Account age	**Write-off PCT**	**Amount Outstanding ($MM)**	**Weight**	**B*D**
0-30	0.10%	$ 80.00	0.6612	0.066%
31-60	0.20%	$ 25.00	0.2066	0.041%
61-90	1.50%	$ 10.00	0.0826	0.124%
91-120	3.00%	$ 4.00	0.0331	0.099%
>120	10.00%	$ 2.00	0.0165	0.165%
		$ 121.00		***0.496%***

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Analytics:
- Update historical data for column B
- Adjust current data in column C
- Recalculate weighted average

Q-factor
- Qualitative adjustments for expected economic conditions

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91-120	3.00%	$ 4.00	0.0331	0.099%
>120	10.00%	$ 2.00	0.0165	0.165%
		$ 121.00		***0.496%***

Enhancing the model

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Lease Accounting

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Operating Leases

- Old rule: Operating leases held off the balance sheet
- New rule: Operating leases capitalized and put on the balance sheet
- Capitalization process:
  - Measure fair value of the leased asset
  - Measure annual lease payments over the term of the lease
  - Calculate present value of the lease payments using an appropriate capitalization (discount) rate
  - Record the lower of the fair value or capitalized lease payment value on the balance sheet at lease inception
  - Reduce lease liability and record interest expense as lease payments are made

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Operating lease capitalization example

- Lease equipment having a fair value of $250,000
- Annual payments of $59,953.97 at the beginning of each year
  - Assumes a lessor cap rate of 10%
- Company cost of capital is 9%
- Present value of payments at 9%: $254,188.05
- Record the lease as an asset and liability at the lower value: $250,000
- Split annual payments into lease amortization and interest

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Payments and Financial Statement Impacts

Fair value	$ 250,000.00	Amortization and Interest allocation assumes payments are made at the beginning of each year with interest collected in arrears
Lessor cap rate	10%	
Annual payments	($59,953.97)	
Company cost of capital	9%	
PV lease payments	$254,188.05	

Payment	Amount	Interest	Lease Amortization	Net Lease balance
Initial				$250,000.00
1	($59,953.97)	$ -	$59,953.97	$190,046.03
2	($59,953.97)	$ 19,004.60	$40,949.37	$149,096.66
3	($59,953.97)	$ 14,909.67	$45,044.31	$104,052.35
4	($59,953.97)	$ 10,405.23	$49,548.74	$ 54,503.61
5	($59,953.97)	$ 5,450.36	$54,503.61	$ -
Totals	($299,769.86)	**$49,769.86**	**$250,000.00**	

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Financial Statement and Ratio Impact Examples

- Department store chains
  - Kohl’s
  - Target

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Kohl's Stores			
CONSOLIDATED BALANCE SHEETS - USD ($) $ in Millions	Aug. 03, 2019	Feb. 02, 2019	Aug. 04, 2018
Current assets:			
Cash and cash equivalents	$ 625	$ 934	$ 1,066
Merchandise inventories	3,656	3,475	3,572
Other	397	426	404
Total current assets	4,678	4,835	5,042
Property and equipment, net	7,276	7,428	7,635
Operating leases	***2,428***		
Other assets	160	206	238
Total assets	14,542	12,469	12,915
Current liabilities:			
Accounts payable	1,330	1,187	1,404
Accrued liabilities	1,199	1,364	1,174
Income taxes payable	34	64	70
Current portion of:			
Finance leases and financing obligations	119	115	122
Operating leases	***158***		
Total current liabilities	2,840	2,730	2,770
Long-term debt	1,855	1,861	2,273
Finance leases and financing obligations	1,270	1,523	1,537
Operating leases	***2,647***		
Deferred income taxes	254	184	188
Other long-term liabilities	221	644	660
Shareholders’ equity:			
Common stock	4	4	4
Paid-in capital	3,236	3,204	3,163
Treasury stock, at cost	(11,353)	(11,076)	(10,835)
Accumulated other comprehensive loss			(8)
Retained earnings	13,568	13,395	13,163
Total shareholders’ equity	5,455	5,527	5,487
Total liabilities and shareholders’ equity	$ 14,542	$ 12,469	$ 12,915
Total Interest bearing Debt/Total Assets	***42%***	***28%***	***30%***

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	Aug. 03, 2019	Feb. 02, 2019	Aug. 04, 2018	Feb. 01, 2018
Assets				
Operating leases	***$ 2,428***			
Total assets	$ 14,542	$ 12,469	$ 12,915	$ 13,389
Current liabilities:				
Accounts payable	$ 1,330	$ 1,187	$ 1,404	
Accrued liabilities	$ 1,199	$ 1,364	$ 1,174	
Income taxes payable	$ 34	$ 64	$ 70	
Current portion of:				
Finance leases and financing obligations	$ 119	$ 115	$ 122	
Operating leases	***$ 158***			
Total current liabilities	$ 2,840	$ 2,730	$ 2,770	
Long-term debt	$ 1,855	$ 1,861	$ 2,273	
Finance leases and financing obligations	$ 1,270	$ 1,523	$ 1,537	
Operating leases	***$ 2,647.00***			
Total Interest bearing Debt/Total Assets	***42%***	***28%***	***30%***	
Sales	$ 8,517		$ 8,778	
Average Assets	$ 13,506		$ 13,152	
Total Asset Turnover (Annualized)	***1.26***		***1.33***	
Average assets without lease	$ 12,292			
Total Asset Turnover (Annualized)	***1.39***			

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Target Corp.			
Consolidated Statements of Financial Position - USD ($) $ in Millions	Aug. 03, 2019	Feb. 02, 2019	Aug. 04, 2018
Assets			
Cash and cash equivalents	$ 1,656	$ 1,556	$ 1,180
Inventory	9,122	9,497	9,112
Other current assets	1,341	1,466	1,211
Total current assets	12,119	12,519	11,503
Property and equipment			
Land	6,054	6,064	6,074
Buildings and improvements	29,908	29,240	28,629
Fixtures and equipment	5,622	5,912	5,356
Computer hardware and software	2,627	2,544	2,575
Construction-in-progress	667	460	685
Accumulated depreciation	(18,866)	(18,687)	(18,147)
Property and equipment, net	26,012	25,533	25,172
Operating lease assets	***2,062***	***1,965***	***1,976***
Other noncurrent assets	1,373	1,273	1,345
Total assets	41,566	41,290	39,996
Liabilities and shareholders' investment			
Accounts payable	9,152	9,761	9,116
Accrued and other current liabilities	4,059	4,201	3,878
Current portion of long-term debt and other borrowings	1,153	1,052	1,044
Total current liabilities	14,364	15,014	14,038
Long-term debt and other borrowings	10,365	10,223	10,108
Noncurrent operating lease liabilities	***2,111***	***2,004***	***2,028***
Deferred income taxes	1,082	972	828
Other noncurrent liabilities	1,808	1,780	1,827
Total noncurrent liabilities	15,366	14,979	14,791
Shareholders' investment			
Common stock	43	43	44
Additional paid-in capital	6,114	6,042	5,788
Retained earnings	6,461	6,017	6,058
Accumulated other comprehensive loss	(782)	(805)	(723)
Total shareholders' investment	11,836	11,297	11,167
Total liabilities and shareholders' investment	$ 41,566	$ 41,290	$ 39,996

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Next Steps

- CECL
  - Develop standard models for estimating bad debt reserves
  - Integrate standard models into robotic process automation outputs
  - Develop a position paper for the B2B credit community on acceptable bad debt reserve methods under CECL
- Leases
  - Financial statement studies of lease reporting impacts
  - Examine how changes in reporting affects credit assessment and management (e.g., scoring models, credit lines, etc.)

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Questions and/or Comments

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