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# FASB provides guidance on recoveries and extension options under credit losses standard

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## KPMG reports on ASU 2019-04[1], which changes how a company considers recoveries and extension options when estimating expected credit losses.

### Applicability

Companies that hold financial assets that are measured at amortized cost[2], which excludes available-for-sale debt securities. Lending portfolios are likely to be most significantly affected.

### Key facts and impacts

The ASU makes several changes to how companies will estimate expected credit losses, including two changes that will likely have the most significant effect.

— **Expected recoveries.** The ASU clarifies that the estimate of expected credit losses should include expected recoveries of financial assets, including recoveries of amounts expected to be written off and those previously written off.

— **Extension or renewal options.** The ASU clarifies that contractual extension or renewal options that are not unconditionally cancellable by the lender are considered when determining the contractual term over which expected credit losses are measured.

Companies will likely need to develop new processes and internal controls to incorporate these clarifications.

The ASU also makes targeted codification improvements to the recognition and measurement of financial assets and the derivatives and hedging standard. This publication focuses on a subset of the ASU's changes that we believe will be the most significant.

### Expected recoveries

For financial assets measured at amortized cost, the ASU requires a company to:

— deduct (or add) the allowance for credit losses from (to) the amortized cost of financial assets to present the net amount expected to be collected on the financial assets; and

— recognize writeoffs of financial assets in the period in which they are deemed uncollectible.

[1] ASU 2019-04, Codification Improvements to Topic 326, Financial Instruments—Credit Losses; Topic 815, Derivatives and Hedging; and Topic 825, Financial Instruments

[2] ASC 326-20, Financial Instruments—Credit Losses—Measured at Amortized Cost

The following table summarizes how to recognize expected recoveries for financial assets measured at amortized cost.

| Requirements under ASU 2016-13[3] | Requirements under ASU 2019-04 |
|---|---|
| **Expected recoveries of amounts expected to be written off** | |
| Expected recoveries of amounts expected to be written off are included when estimating the allowance for expected credit losses. This is because the allowance is subtracted from the amortized cost basis to arrive at a net amount that is expected to be collected. | The ASU did not affect how these amounts are considered under ASC 326-20 when estimating the allowance for expected credit losses.<br>Additionally, we believe the requirements under ASU 2019-04 are consistent with practice for the majority of financial institutions under the current US GAAP incurred loss model. |
| **Expected recoveries of amounts previously written off** | |
| The credit losses standard only permits a company to recognize recoveries of financial assets previously written off when they are received (i.e. on a cash basis). | The ASU changes the guidance in ASC 326-20 to **require** a company to estimate recoveries that it expects to receive from financial assets that have previously been written off when it estimates its allowance for expected credit losses.<br>We believe practice for the majority of financial institutions under the current US GAAP incurred loss model is to recognize these amounts when received. The requirements under ASU 2019-04 will change this practice. |

Considering recoveries of previously written off financial assets in the estimate of expected credit losses may, in limited circumstances, result in the allowance for credit losses being negative (i.e. a debit balance). The negative allowance for credit losses may not exceed amounts previously written off.

**KPMG observation**

To prepare for implementation, a company will likely need to change its processes and related controls, including taking these actions.

- Monitoring financial assets, including those that were fully written off in earlier periods, for potential recoveries. A company will need to consider loans (or portfolios of loans) for which a recovery would potentially be significant.
- Capturing historical information about recoveries. This might include information about historical recovery experience (i.e. recovery rates); historical time periods between when the writeoff occurs and when recovery is received; and changes in collection practices that may have affected a company's historical recovery experience.

The following example illustrates one approach for applying the ASU's guidance.

[3] ASU 2016-13, Measurement of Credit Losses on Financial Instruments

### Example

**Expected recoveries of amounts expected to be written off**

Bank has a portfolio of loans with an amortized cost of $100 million.

It estimates that it will:

- fully write off 4% of these loans – $4 million; and
- recover 20% of written off amounts – $800,000.

This component of the allowance for credit losses is: $4 million – $800,000 = **$3.2 million.**

**Expected recoveries of amounts previously written off**

Bank has $3 million of similar loans that were fully written off during each of Year 1 and Year 2 because each loan was deemed uncollectible.

Bank's historical recovery rate for these types of loans is 20%, which it expects to continue in the future.

For simplicity of this example, assume that Bank:

- does not expect to recover any amounts on loans written off before Year 1; and
- has not yet received any recoveries of amounts written off in either Year 1 or Year 2.

This component of the allowance for credit losses is: $3 million per year × 2 years × 20% = **$1.2 million** (this component will partially offset the amount in the first component).

**Allowance for credit losses**

The allowance for credit losses equals the combination of these two components: $3.2 million – $1.2 million = **$2 million.**

## Extension or renewal options

The credit losses standard for financial assets measured at amortized cost requires a company to estimate expected credit losses over a financial asset's contractual term. The guidance was not clear about whether contractual features that allowed the maturity date to be extended should be included in a financial asset's contractual term.

Under the ASU's requirements, an extension or renewal option that is not unconditionally cancellable by the company (e.g. lender) affects a financial asset's contractual term and the resulting estimate of expected credit losses, unless the option is accounted for as a derivative. This includes a borrower's right to extend the maturity date that is either unilateral (i.e. unconditional) or that is conditional (i.e. contingent on events beyond the lender's control). In either scenario, the lender cannot avoid extending the maturity date and should measure the allowance for credit losses by considering the expected effects of the term extension or renewal option and the likelihood of exercise.

In contrast, a lender does not adjust a financial asset's contractual term for an extension or renewal option that the lender can unconditionally cancel, even if the lender has a past practice of extending the term.

### KPMG observation

We believe many companies may not currently track extension or renewal options and how often these options have been exercised. To prepare for implementation, a company will need to consider whether and how its estimate of the allowance for credit losses incorporates the credit risk related to these options.

Some companies may need to change their existing processes and related controls to:

- identify whether contracts contain contractual extension or renewal options that are not unconditionally cancellable by the company (i.e. are not in the company's control);
- capture information necessary to estimate the likelihood that the renewal or extension options will be exercised, including the likelihood the contingent events will occur; and
- measure the effect of the potential extension period on the estimate of expected credit losses.

**KPMG observation**

We believe it generally would not be appropriate to assume that all (or no) extension or renewal options will be exercised if that assumption does not reflect a company's historical experience, unless the company can demonstrate that the current facts and circumstances have changed from its historical experience in a manner that supports the assumption.

## Effective dates and transition

<table>
<tr><th rowspan="2"></th><th colspan="2">Credit losses standard adopted?</th></tr>
<tr><th>Yes</th><th>No</th></tr>
<tr><td>Annual and interim periods – Fiscal years beginning after</td><td>December 15, 2019</td><td rowspan="2">The effective dates and transition requirements are the same as the credit losses standard.</td></tr>
<tr><td>Early adoption allowed?</td><td>Yes, in any interim period if the company has adopted the credit losses standard.</td></tr>
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**KPMG's Financial Reporting View**
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