KPMG

Hot Topic: Q1 Economic events

Potential impacts of economic disruption on expected credit losses under ASC 326

March 16, 2020

Economic disruption resulting from the coronavirus and oil-markets should not be reflected in a company's adjustment for transitioning to ASC 326.

Background and impacts on expected credit losses

Stock markets around the world have reacted to the economic impacts, and potential additional economic impacts, of the novel coronavirus (COVID-19). Further, two of the world's three largest oil producers have failed to agree on a response to depressed demand caused by the outbreak, triggering a price dispute that led to a sharp decline in oil prices and further economic disruption. Global markets have seen decreases in value and are experiencing volatility in asset prices, currency exchange rates and commodities indices.

ASC 326 is effective on January 1, 2020 for public business entities that are not eligible to be smaller reporting companies and that have a calendar year-end, with early adoption available for other companies. ASC 326 replaces the current incurred loss impairment model, under which credit losses are recognized when a probable threshold is met, with a requirement to estimate and recognize credit losses for the lifetime of assets within its scope. Estimating lifetime credit losses includes estimating the effect of economic conditions that will affect the collectibility of the reported amounts, including current economic conditions and reasonable and supportable forecasts of future economic conditions.

We believe that the economic disruption resulting from COVID-19 and the decline in oil prices during the first quarter should not be reflected in a company's estimate of credit losses under ASC 326 as of January 1, 2020 (i.e. its 'transition adjustment') because it occurred subsequent to January 1, 2020. Instead, we believe the disruption represents a change in economic conditions that arose after – and affects estimated credit losses arising after – the adoption date. That is, it is a nonrecognized subsequent event (ASC 855) as it relates to the transition adjustment.[1]

---

[1] ASC 855-10-55-2(e)

ASC 326 does not prescribe whether an entity's estimate of expected credit losses should be based on the single economic scenario the entity believes is most likely, or a probability-weighted approach that considers multiple possible economic scenarios. Regardless of the approach used, we believe that the economic scenarios (and the probability weighting applied to those scenarios, if applicable) should generally be based on:

— information available at the adoption date; and
— information available after the adoption date that relates to recognized subsequent events. Recognized subsequent events are those that provide additional evidence about conditions that existed at the adoption date.

Although the first case of the novel coronavirus was reported on December 31, 2019, very little was known about it, or its potential impact on the global economy, on that date and the extensive spread of the virus outside of China that caused broad global economic impacts had not yet occurred. Additionally, the pricing dispute between oil producing nations that triggered significant oil price declines had not yet escalated or occurred. As a result, the impact of the novel coronavirus and the oil pricing dispute, and resulting economic effects, occurring in the first quarter of 2020 should be included in forecasts of economic conditions used to estimate the allowance for expected credit losses for periods subsequent to initial application at January 1, 2020.

See also our other related Hot Topics issued on:

— February 7, 2020, which discusses potential impacts that COVID-19 may have on reporting for SEC issuers, including disclosures related to business risks.
— March 5, 2020, which discusses regulatory relief provided by the SEC for companies impacted by COVID-19.