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July 29, 2019

Mr. Shayne Kuhaneck
Acting Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

RE: Proposed Accounting Standards Update, *Codification Improvements to Topic 326, Financial Instruments–Credit Losses* (File Reference No. 2019-710)

Dear Mr. Kuhaneck:

We appreciate the opportunity to comment on the proposed ASU, *Codification Improvements to Topic 326, Financial Instruments–Credit Losses*.

We support the Board's efforts to respond to stakeholder questions associated with implementing the impairment standard, and believe that the proposals would address those questions and assist preparers in implementing the standard.

We agree with the Board's decision to include expected recoveries of amounts previously written off in the estimate of expected credit losses for purchased financial assets with credit deterioration (PCD) assets, because we believe there should be consistency in estimating expected credit losses for PCD and non-PCD assets. However, we believe the Board should consider changing the proposed limitation on recoveries to prevent accelerated recognition of income when financial assets are written off by an entity that uses a method other than a discounted cash flow method to estimate expected credit losses.

Often, an entity will write off a financial asset because it has determined that the individual asset is uncollectible, even though the entity may have a reasonable expectation of recoveries for the larger portfolio that includes that financial asset. This situation can occur if each individual asset has a low likelihood of recovery, but when viewed in aggregate as a larger pool there is a much higher likelihood of recovery. As we illustrate in the Appendix, if an entity fully writes off PCD financial assets in that circumstance, and applies a method other than a discounted cash flow method to estimate expected credit losses, the writeoff of the financial assets generally, under the Board's proposals, results in a net recognition of income. We do not believe that the writeoff of a financial asset should result in the net recognition of income. We also note that recognition of income as a result of a writeoff would be inconsistent with the accounting for non-PCD assets (for which a writeoff would not result in net recognition of income).

We believe it is important for an entity to continue to recognize the initial difference between an asset's purchase price and amounts it expects to collect (i.e. the expected profit) in earnings over the life of the financial asset, even if an individual asset is written off. For that reason, we recommend that when an entity applies a method other than a discounted cash flow method, the Board further enhance its proposed limit on the negative allowance for PCD assets with the objective of ensuring that a writeoff does not, in and of itself, result in the accelerated recognition of income.

We also recommend that the Board separately address the timing of income recognition when an entity expects to receive cash flows in excess of the limit.

The Appendix provides our responses to selected questions in the proposed ASU. As part of those responses, we included additional recommendations for the Board to consider.

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If you have questions about our comments or wish to discuss the matters addressed in this comment letter, please contact Kimber Bascom at (212) 909-5664 or kbascom@kpmg.com or Mark Northan at (212) 954-6927 or mnorthan@kpmg.com.

Sincerely,

KPMG LLP

KPMG LLP

Appendix – Responses to Selected Questions for Respondents

General Questions

Question 1: Should other changes be made that are directly or indirectly related to amendments in this proposed Update? Please note that the Board will conduct Codification improvement projects on a periodic basis and additional changes may be postponed to a subsequent Codification improvement project.

Yes. We believe the Board should consider clarifying that for purposes of measuring expected credit losses for a net investment in a lease under Topic 842 (leases) the lease term (as defined in Topic 842) should be used instead of the contractual term. While this approach would be a departure from the measurement of expected credit losses for other assets within the scope of the credit losses standard, it would align the measurement of the allowance for expected credit losses with the amounts recognized on the balance sheet (because it would ensure that the estimate of expected credit losses relates to the respective amounts of lease rentals and unguaranteed residual values used in measuring the net investment in the lease recorded on the balance sheet).

Issue 1: Negative Allowance for PCD Assets

Question 3:

Should an entity be permitted to record a negative allowance (basis recovery) when measuring the allowance for credit losses for purchased financial assets with credit deterioration?

Yes. We agree with the Board's proposal to include expected recoveries of amounts previously written off in the estimate of expected credit losses for PCD assets so that there is consistency in estimating expected credit losses between PCD and non-PCD assets.

Question 4:

Should a negative allowance (basis recovery) for PCD assets be limited to the amortized cost basis previously written off and expected to be written off by the entity? If not, please explain why and what changes should be made instead.

No. We believe that the Board should consider changing the proposed limitation on recoveries to prevent accelerated recognition of income when financial assets are written off by an entity that uses a method other than a discounted cash flow method to estimate expected credit losses.

We also recommend that the Board clarify whether an entity would apply a negative allowance limit at an individual asset or pool level.

Further, we recommend that the Board provide guidance about income statement recognition for amounts an entity expects to collect in excess of the negative allowance limit and whether (and how) an entity is required to apply the nonaccrual guidance in Subtopic 310-10 to a negative allowance.

These recommendations are explained in more detail in the sections that follow.

The negative allowance should be further limited to prevent a writeoff from accelerating the recognition of income when a method other than a discounted cash flow method is used to estimate expected credit losses

When a PCD asset is initially recognized, its amortized cost basis is the sum of the purchase price and the amount of the initial allowance for credit losses (which, unless a discounted cash flow method is used, is measured based on the unpaid principal expected to be collected). When a method other than a discounted cash flow method is applied, the difference between the principal payments expected to be collected and the purchase price (i.e. the expected profit) is recorded as a noncredit discount. This noncredit discount is required to be recognized over the life of the financial asset using the effective interest method (unless the asset is determined to be nonaccrual).[1]

Often, an entity will write off a financial asset because it has determined that the individual asset is uncollectible, even though the entity may have a reasonable expectation of recoveries for the larger portfolio that includes that financial asset. This situation can occur if each individual asset has a low likelihood of recovery, but when viewed in aggregate as a larger pool there is a much higher likelihood of recovery. If an entity writes off PCD financial assets in that circumstance, and applies a method other than a discounted cash flow method to estimate expected credit losses, the writeoff of the financial asset generally, under the proposals, results in a net recognition of income. We do not believe that the writeoff of a financial asset should result in the net recognition of income. We also note that recognition of income as a result of a writeoff would not be consistent with the accounting for non-PCD assets (for which a writeoff would not result in net recognition of income).

To address these concerns, we recommend that when a method other than a discounted cash flow approach is used, the limit should be the purchase price plus any increases (or decreases) in expected cash flows since the date of acquisition. This treatment of changes in expected cash flows ensures that changes in expected cash flows occurring *after* an asset is written off are recognized in the income statement consistently with how they are recognized *before* an asset is written off (that is, to ensure consistency in the pre- and post-writeoff models).[2]

<u>The following example illustrates the accelerated recognition of income under the Board's proposed approach and how our recommendation would address the issue.</u>

Assume that Entity pays $250 to acquire portfolio of loans with an unpaid principal balance of $1,000. Entity expects to collect contractual principal cash flows of $400. Immediately following the acquisition, Entity concludes that the individual loans in the portfolio are uncollectible, writes them off, and establishes a negative allowance for the principal cash flows of the portfolio that it expects to collect. Entity uses a method other than a discounted cash flow method to measure

[1] ASC paragraph 310-10-35-53B – 35-53C

[2] Under paragraph 326-20-35-1, changes in expected cash flows are recognized in the income statement; this guidance applies to PCD assets even though the initial allowance for credit losses is not recognized through earnings. The Board could also consider increasing the limit for interest income accrued or accreted but not received before writeoff.

expected credit losses. The following tables summarize the journal entries and related financial statement effects under the Board's proposed approach and under our recommended approach.

Entries	***Proposed amendments:*** *Negative allowance limit is amortized cost basis*		***Our recommended approach:*** *Negative allowance is limited by purchase price*	
	Debit	*Credit*	*Debit*	*Credit*
PCD loans	1,000		1,000	
Cash		250		250
Allowance for credit losses[1]		600		600
PCD loans – non-credit discount		150		150
To recognize acquisition of PCD loans, estimate of expected credit losses and noncredit discount				
Credit loss expense	250		250	
Allowance for credit losses		250		250
To establish an allowance for PCD loans' full amortized cost basis before write-off				
Allowance for credit losses	850		850	
PCD loans – non-credit discount	150		150	
PCD loans		1,000		1,000
To write off PCD loans				
Allowance for credit losses[2]	400		250	
Credit loss expense		400		250
To establish negative allowance for PCD loans				

Notes:

1. Calculated as $1,000 (unpaid principal balance) – $400 (principal that Entity expects to collect)
2. Calculated as the lesser of $400 (the amount expected to be collected) or the respective limit (i.e. $850 amortized cost basis written off [proposed amendments] or $250 purchase price [our recommended approach])

The result of the above entries on the financial statements is:

Account	***Proposed amendments:*** *Negative allowance limit is amortized cost basis*	***Our recommended approach:*** *Negative allowance is limited by purchase price*
Balance sheet – assets		
Allowance for credit losses	($400)	($250)
Income statement		
Credit loss expense (income)	($150)	—

While this example illustrates an entity that acquires and immediately writes off a portfolio of PCD assets, a similar result would occur if an entity wrote off PCD assets at a subsequent date.

The Board's approach to limiting the negative allowance for PCD assets would result in different income statement effects as compared with the effects for non-PCD assets when a method other than a discounted cash flow method is used to estimate expected credit losses, even if an entity's expectations remain the same for both types of assets. Our proposed approach would align the income statement effects for writeoffs of PCD and non-PCD assets.

For example, if a portfolio of assets is originated (i.e. non-PCD assets) for $1,000 with $1,200 in total contractual payments due over the life of the instrument, the profit of $200 is required to be recognized over time. If these assets are charged off at a future date, the negative allowance is limited to $1,000 and the unearned income (i.e. contractual interest or an unamortized discount) is not included in earnings at the date of writeoff. This is because the amortized cost basis is equal to the cash outlay at the asset's origination (plus interest income accrued or accreted but not received before writeoff). This would be the result for non-PCD loans regardless of whether the difference between $1,000 and $1,200 relates to contractual interest or an origination discount (i.e. as a result of a below-market interest rate).

The outcome for PCD assets should be the same. For example, if a PCD asset is acquired for $1,000 with an expectation that the entity will collect $1,200 in total principal payments over the life of the instrument, the expected profit of $200 is required to be recognized over time (similar to non-PCD assets). However, under the Board's proposals for PCD assets, when a method other than a discounted cash flow method is used to estimate expected credit losses the negative allowance the limit will generally be at least $1,200[3] and the remaining discount / unearned income would be included in earnings at the date of writeoff. This would occur because the amortized cost basis for a PCD asset is not equal to the cash outlay at the asset's acquisition. Under our recommended approach, the previously unrecognized income would not be included in earnings at the date of writeoff, consistent with the outcome for non-PCD assets.

[3] This assumes that the unpaid principal amount of the loan(s) is at least $1,400.

The Board states in paragraph BC10 of the Basis for Conclusions that it did not use the purchase price as the limit because doing so would result in an inconsistency between the pre-and post-writeoff models. We believe the Board is referring to situations in which an entity is recognizing improvements in cash flows in earnings in the period in which it determines that there has been an improvement. However, the issue explained above does not represent an improvement in expected cash flows and, therefore, is different. This issue involves potential recognition of income *at* the time of writeoff that was required to be recognized over time *before* writeoff. Therefore, if the Board's objective is, as described in BC10, to maintain consistency in its pre- and post-writeoff models, we recommend that it ensure that income is not accelerated by writing off the financial asset.

Clarification is needed regarding whether the cap should be applied at the individual asset level

The proposed guidance provides a limitation on the negative allowance for PCD assets, but does not specify whether the limitation would be applied at the individual asset level or the portfolio level. The proposed amendments in paragraph 326-20-30-13A state that "An entity shall not include recoveries of the unamortized noncredit discount or premium in the allowance for credit losses." Because 326-20-30-13 requires the noncredit discount or premium to be allocated to each individual asset, this statement suggests the limitation should be applied at the individual asset level. We believe the Board should clarify this issue. If the Board intends to permit the limitation to be applied at a portfolio level, we believe the Board should state that explicitly, and should remove the aforementioned sentence from paragraph 326-20-30-13A. If the Board intends for the limitation to always be applied at the individual asset level, it should retain the aforementioned sentence in paragraph 326-20-30-13A.

<u>The following example illustrates this issue.</u>

Assume Entity acquires a portfolio of 100 loans, each having a par amount of $100, and accounts for those loans as PCD assets. Entity allocates the allowance for credit losses and noncredit discount resulting from acquisition to the individual loans in the pool, resulting in each loan having an amortized cost of $85 (i.e. 85% of par) and a noncredit discount of $15. Entity concludes that each of the assets in the pool are uncollectible on an individual basis and writes them off in their entirety. However, Entity believes that it will collect *all* contractual cash flows on 30% of the loans (although it cannot specifically identify those loans) but *no* cash flows on the other 70%. If the limit is applied at the portfolio level, Entity would recognize a negative allowance for loan losses of $3,000 (which is less than the amortized cost of the pool that was written off, i.e. $8,500) for the loans for which it expects to collect all cash flows. This contrasts with the $2,550 amount it would recognize if the limit is applied at the individual level.

Asset	Amount written off (amortized cost basis)[1]	Amount expected to be recovered	Allowance for credit losses (debit)	
			Cap applied at asset level	Cap applied at pool level
30% of loans: All cash flows expected	$2,550	$3,000	$2,550	$3,000
70% of loans: No cash flows expected	$5,950	$0	$0	
Collective pool	**$8,500**	**$3,000**	**$2,550**	**$3,000**

1. Calculated as % of pool in the tier × $10,000 par of pool × 85% (amortized cost as a % of par)

Applying the limitation at a portfolio level would be consistent with the Board's previous decision to permit an entity to consider recoveries on a pool basis when measuring the allowance for credit losses.[4] We believe it would also be less burdensome to apply. However, applying the limit at this level may result in an extremely low likelihood that the limit will be met in almost all circumstances other than when the allowance for credit losses is measured for an individual financial asset. This is because it is unlikely that recoveries on a portion of a portfolio of assets written off would exceed the amount written off for the entire portfolio. As a result, applying the limitation at the portfolio level would result in including in the allowance for expected credit losses cash flows that exceed the previous carrying amount of the individual asset. This could include cash flows related to contractual interest amounts that have not yet been earned or, in certain circumstances, expected proceeds from collateral that exceed the previous carrying amount of the related loan.

Applying the limitation at the individual asset level would prevent cash flows that exceed the previous carrying amount of the financial asset from being included in the allowance for credit losses. However, it may also be more challenging operationally and therefore could require additional time for preparers to implement the proposals (see also our response to Question 9).

Guidance is needed for amounts expected to be collected in excess of the limit

While the Board's proposals would establish a limit on the negative allowance, they do not explain how an entity would recognize amounts in excess of that limit. We believe the Board should address income statement measurement issues that would arise under its proposals.

[4] Paragraph BC38 of ASU 2019-04 states that "an entity should consider recoveries when measuring the allowance for credit losses on either an individual or a pool basis."

The following example illustrates this issue.

Assume Entity previously wrote off a PCD loan with a par amount of $100. Due to subsequent changes in circumstances, Entity expects to collect all cash flows (i.e. $100), however the negative allowance for that loan is limited to $85.[5]

It is not clear when Entity would recognize the additional $15 of income. We recommend that the Board consider the following alternatives for income recognition.

- *Recognize income based on the first cash flows received*. Without additional guidance from the Board, this is the approach that may be interpreted from the proposed amendments. Under this alternative, if a method other than a discounted cash flow method is used, we believe Entity would recognize income for the *first* $15 of cash flows received after it expects to collect $100. This is because when Entity receives $15, it would record a recovery with a corresponding reduction to the negative allowance, and would then restore the negative allowance to $85 (which is the limit) with a corresponding reduction in credit loss expense of $15.
- *Recognize income using a cost recovery method:* Under this alternative, the additional $15 would be recognized in income only after $85 had been collected. This would have the effect of recognizing the *last* expected cash flows received as income.
- *Recognize income over time*: Under this alternative, an entity would recognize the difference between its estimate of expected cash flows and the negative allowance (which could be less than the expected cash flows because of the limitation) ratably over time.

It is not clear whether income statement guidance for financial assets should be applied to a negative allowance

We believe an entity should accrue interest on a negative allowance (by unwinding the time value of money element inherent in the allowance) when the entity has a reasonable expectation of cash flows at a portfolio level, however we believe that this issue should be clarified by the Board.

Paragraph 310-10-35-53C states that "Recognition of income on purchased financial assets with credit deterioration is dependent on having a reasonable expectation about the amount expected to be collected." It is not clear whether that guidance precluding recognition of income would apply to a negative allowance. If the guidance would apply to a negative allowance, it is not clear whether an entity would apply the guidance in that paragraph at the portfolio level or the individual asset level.

We recommend that the Board clarify that the guidance in paragraph 310-10-35-53C applies to the negative allowance, and that the recognition of income in that paragraph should be dependent on having a reasonable expectation about the amount expected to be collected at the portfolio level.

[5] The $85 limit could result from application of either the Board's proposal based on amortized cost or under our recommended approach based on the purchase price adjusted for changes in expected cash flows.

<u>The following example illustrates this issue.</u>

Entity applies a discounted cash flow method for measuring expected credit losses and has a portfolio of assets for which it does not, on an individual asset basis, have a reasonable expectation of cash flows. Under paragraph 310-10-35-53C, it places those assets on nonaccrual status (i.e. ceases to recognize interest income).

Subsequently, Entity concludes that certain of these assets are uncollectible and writes them off, even though it is likely that some of them will have recoveries and, as a group, those recoveries can be reasonably estimated.

Following the writeoff, Entity recognizes the net present value of the amounts expected to be collected in its estimate of the allowance for credit losses.

Under our recommended approach, Entity would accrue interest on the negative allowance (by unwinding the time value of money element inherent in the allowance) because it has a reasonable expectation of cash flows at the portfolio level.

Transition and Effective Date

Question 9: Will the proposed effective dates provide sufficient time for entities to implement the proposed amendments? If not, please explain why and how much time would be needed to adopt the proposed amendments.

Not in all cases. Many entities are preparing to implement ASU 2016-13 as of January 1, 2020 and may be constrained in their ability to significantly change their processes and related controls before that date.

In addition, ASU 2019-04, which requires an entity to recognize expected recoveries of amounts previously written off or expected to be written off (for assets other than PCD assets), is required to be implemented concurrently with adoption of ASU 2016-13. As a result, if the proposed amendments in this proposed ASU are not adopted concurrently with the adoption of ASU 2016-13, an entity would be required to change its processes and related controls related to recoveries twice (i.e. first for ASU 2019-04 and then for this proposed ASU).

To address these concerns, the Board should consider an effective date of January 1, 2021 (for public companies that are SEC filers) for the recoveries guidance in both ASU 2019-04 and this proposed ASU. In addition, we believe the Board should permit early adoption if the recoveries guidance in both ASUs is adopted at the same time. An entity not adopting the recoveries guidance in 2020 would recognize recoveries of amounts previously written off when received.[6] This approach would allow entities more time to adopt the guidance in the proposed ASU without requiring them to make changes to processes and related controls in successive reporting periods. It would also provide entities with the option of adopting all of the guidance at January 1, 2020.

[6] Under our recommended approach, entities not adopting the recoveries guidance in 2020 would follow the guidance in paragraph 326-20-35-8 from ASU 2016-13 (i.e. prior to ASU 2019-04) when it adopts ASU 2016-13 for both non-PCD and PCD assets.