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28 June 2013

Dear Sir,

Re: Exposure Draft ED/2013/3 Financial Instruments: Expected Credit Losses

We have reviewed the above noted document. The comments that we provided to the IASB are included below. Overall, we agree with the proposals; however, we identified a few areas where increased guidance may be needed to assist in the consistent application of the finalized standard.

In addition to our response to the IASB, we would like to request the AcSB to have the illustrative examples and the basis for conclusions translated into French and included in the CICA Handbook – Part I. These documents help users understand a standard's requirements. They often contain additional insights and clarifications that help users apply the standards consistently and aid in the research of complex accounting issues. While it will be beneficial to have the documents in the CICA handbook for all IFRSs, new standards, such as the financial instruments and expected credit loss requirements once enacted, should be prioritized.

Question 3: Do you agree with the proposed scope of this Exposure Draft? If not, why not?

Our concern relates to the following items as included in the proposed scope:
1. Loan commitments when there is a present contractual obligation to extend credit, except any loan commitments that are accounted for at fair value through profit or loss in accordance with IFRS 9; and
2. Financial guarantee contracts within the scope of IFRS 9 that are not accounted for at fair value through profit or loss.

Each of these items has been discussed in more detail below.

Loan commitments:

Paragraph BC126 of the Basis for Conclusions on the exposure draft clarifies that an entity that can withdraw its loan commitments before extending credit does not have a present obligation to extend credit. Without this clarification in the basis for conclusions, we understand that a user would have had to look to IAS 37 Provisions, Contingent Liabilities and Contingent Assets paragraphs 15 – 16 and the Conceptual Framework for Financial Reporting paragraph 4.15 – 19 to determine the meaning of "present obligation". While an experienced IFRS user would be able to interpret the appropriate meaning from these paragraphs, they do not directly apply to loan commitments. Accordingly, there is a risk of misinterpretation of the scope especially by users that are less familiar with IFRS or recently adopted IFRS. Therefore, we recommend that the BC126 clarification be included within the actual standard to clarify that a revocable loan commitment does not constitute a present obligation to extend credit.

Financial Guarantee contracts

Some financial guarantee contracts automatically extend while others require specific approval by the party providing the guarantee. Users may not appropriately consider such guarantee contracts and whether the extended period should be taken into account when determining the expected credit loss provision. Accordingly, we recommend that the financial guarantee scope paragraph, similar to the loan commitments scope paragraph, be clarified so that financial guarantee contract extensions are only included in the scope where there is a present contractual obligation to provide the guarantee.

Question 5 (b): Do the proposals provide sufficient guidance on when to recognise lifetime expected credit losses? If not, what additional guidance would you suggest?

Overall, we think sufficient guidance has been provided on when lifetime expected credit losses should be recognized. However, there is only one area that we think should be clarified to eliminate any confusion. Paragraph B17 and B18 of the exposure draft explains how to evaluate the significance of an increase in credit risk on an individual versus collective basis. This assessment ultimately determines if lifetime versus 12-month expected credit losses will be recognized. We propose that the guidance clearly be split into 2 steps as described below. In addition, please clarify when financial instruments should be included or excluded from the individual or collective evaluation. Based on our interpretation, we have included proposed guidance below.

Suggested guidance:

Step 1: Evaluate on an individual basis whether there is evidence of a significant increase in credit risk using information pertaining to the individual financial instrument only.

Step 2: Evaluate on a collective basis whether there is evidence of a significant increase in credit risk by grouping financial instruments with shared risk characteristics that are indicative of the borrowers' ability to pay all amounts due in accordance with the contractual terms.

Individual financial instruments for which, based on step 1, it was determined that there was a significant increase in credit risk can be excluded from the collective evaluation.

Certain entities may not have detailed information pertaining to an individual financial instrument, in which case the entity will not be able to perform the assessment in step 1. As a result, the entity may perform the assessment only on a collective basis in accordance with step 2.

If, based on step 1, it was determined that there was not a significant increase in credit risk, the financial instrument should be included in the step 2 collective assessment.

Question 6(b): Do you agree with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition? Why or why not? If not, for what population of assets should the interest revenue calculation change?

<u>Concern 1: Definition of objective evidence of impairment</u>

We agree that interest revenue should be recognized on a net carrying amount (amortized cost) rather than on a gross carrying amount for financial instruments where there is objective evidence of impairment. However, the definition of "objective evidence of impairment" and the guidance on determining whether there has been a significant increase in credit risk may make it operationally difficult to distinguish financial instruments in stage 2 and 3 from each other.

We concur with the guidance provided on determining whether than has been a significant increase in credit risk since initial recognition. Therefore, we propose that the definition of "objective evidence of impairment" be revised to clearly show when a financial asset moves from only experiencing a significant increase in credit risk to having objective evidence of impairment. To achieve this we propose the following:

1. It is our understanding that financial instruments in stage 3 would be financial instruments for which a credit loss event/default has actually occurred and the definition lists examples of loss events that may have occurred. This is as opposed to assets in stage 2 for which the probability of default has increased significantly from initial recognition but no actual loss event has occurred. It will be helpful if the standard specifically explains this distinction to help users understand the difference between stage 2 and stage 3 financial instruments.

2. We recommend that the finalized standard defines a default. In our opinion, a default event should only relate to an event that has or is expected to result in a credit loss. This will assist in the calculation of expected credit losses. It will also help distinguish stage 2 from stage 3 as explained in point 1 above.

3. It will also be helpful to expand illustrative examples No 3, 7 and 9 to explain how the entity determines which financial assets have objective evidence of impairment once it has determined that there has been a significant increase in credit risk since initial recognition.

<u>Concern 2: Clarification pertaining to less sophisticated financial institutions</u>

Some less sophisticated financial institutions, such as small credit unions, may not have detailed financial information on the counterparties to which a financial instrument was issued e.g. residential mortgages issued to individuals. The volume of such financial instruments issued makes it impracticable to monitor credit risk on an individual basis until one or more contractual cash flows are in arrears. Cash flows in arrears for a certain time period will usually be regarded as providing objective evidence of impairment since information on the reason for the default may not be available.

For these types of financial instruments an entity will only be able to consider actual or expected adverse changes in economic environment to evaluate whether the instrument falls in stage 2. This may lead to these types of financial instruments moving directly from stage 1 directly to stage 3 because information (other than information on general economic conditions) indicating that the financial instrument should have been in stage 2 was not available to the entity. We propose that the final standard explains that in these situations (i.e. where detailed financial information on a counterparty is not available and credit risk is not monitored closely on an individual level), it is possible for a financial instrument to move directly from stage 1 to stage 3.

Concern 3: Allocation of credit loss allowance to individual financial assets

We understand that it is difficult for some entities to allocate the lifetime expected credit loss allowance calculated on a collective basis to individual financial assets. Therefore, it is difficult for these entities to calculate interest on the net carrying amount (amortized cost) using the individual financial asset's original effective interest rate. Since many of our clients will continue to perform the calculations on a collective basis, we propose that the finalized standard include a practical expedient for allocating the credit loss allowance to individual financial assets when calculating interest on financial instruments in stage 3. For example, would it be appropriate to allocate the credit loss allowance based on the gross carrying amount of the financial assets?

Concern 4: Minor clarification of impact on future cash flows

To clarify that impairment relates to a decrease in future cash flows, we propose that the following strike-through text be removed and the underlined text be included in the objective evidence of impairment definition.

- "One or more events that ~~have an impact on the~~ result in a decrease in expected future cash flows of the financial instruments.

Question 7(b): Do you foresee any specific operational challenges when implementing the proposed disclosure requirements? If so, please explain.

The exposure draft is silent on how the loss allowance will be allocated between current and non-current financial assets. Constituents may incorrectly assume that 12-month expected credit losses should be classified as current. This would be incorrect because the allowance includes expected credit losses over the life of the instrument resulting from default in the next 12 months.

Ideally, the classification of the expected credit loss allowance as current or non-current should follow the classification of the cash flows attributable to the underlying financial asset. This allocation is relatively simple when the underlying asset as a whole is classified as either current or non-current and the lifetime expected credit loss allowance was calculated on an individual basis. It becomes operationally challenging when, based on the timing of the contractual cash flows, a portion of the financial asset is classified as current and a portion as non-current and/or when the expected credit loss allowance was calculated on a collective basis.

We propose that the finalized standard expressly state how credit loss allowances should be classified to eliminate any uncertainties. In addition, practical expedients should be provided for allocating credit loss allowances to current and non-current portions of financial assets, for example, based on the gross carrying amounts (for financial assets that are not originated credit-impaired financial assets) or amortized cost (for originated credit-impaired financial assets).

Question 11: Do you agree with the proposals for financial assets that are credit-impaired at initial recognition? Why or why not? If not, what approach would you prefer?

We understand that the fair value of a financial instrument includes market participants' expectations of future credit losses. Credit risk is also priced into the instrument at origination. As a result, the exposure draft proposes that an expected credit loss allowance be recognized in profit or loss at initial recognition to reflect that the yield on the instrument includes a return to cover those credit losses expected from when a financial instrument is first recognized.

Currently, a financial instrument's amortized cost is always equal to its fair value at initial recognition and credit losses are recognized when incurred. For certain less sophisticated entities, it may seem counter-intuitive to recognize a financial instrument initially at fair value minus a loss allowance, given that the fair value includes an expectation for credit losses.

To help with the application of the finalized standard, we recommend that the IASB include 2 numerical examples within the application material of the standard that demonstrate the journal entries applicable to the initial recognition and a subsequent reporting date. One example should relate to originated-credit impaired financial assets and the other to financial assets that are not originated-credit impaired.

It is our understanding that a day one gain may result if the credit-impaired financial asset is obtained for less than market value. However, the gain will be offset by the credit losses recognized. Since this may also seem counterintuitive for less sophisticated entities, it will be helpful if the illustrative example for originated credit-impaired financial assets also show the interaction with the requirements of IAS 39/IFRS 9 relating to day one/gains or losses.

Question 12: What lead time would you require to implement the proposed requirements? Please explain the assumptions that you have used in making this assessment. As a consequence, what do you believe is an appropriate mandatory effective date for IFRS 9? Please explain.

We expect that the final standard will have a significant effect on our client's financial reporting and other processes. Our clients would require a minimum lead time of 2 years. There is a delay of 3 - 5 months between a standard being issued by the IASB to it being incorporated into Canadian GAAP. This is because the Canadian Accounting Standards Board is an IFRS endorser and the standard needs to be translated into French. As a result, a lead time of 2 years will give users sufficient time to implement changes to their processes and systems before determining the expected credit loss allowance/provision at the date of initial application as defined in C1 of the exposure draft. It is also consistent with the lead time that was given for other newly issued standards like IFRS 10 – 13.

Other recommendations

Many of our financial institution clients are required by their regulators to recognize or maintain a reserve for credit losses. While this reserve is not recognized in their IFRS financial statements it is included in their regulatory reporting. Where the reserve required by the regulator is in excess of the allowance recognized in their IFRS financial statements, the excess is included in equity as a non-distributable reserve. We recommend that the IASB include similar guidance to help entities consistently treat the difference between the expected credit loss allowance/provision and the required regulatory reserve where applicable.

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Yours truly,

MNP LLP

Jody MacKenzie

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