Accounting Standards Board
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Conseil des normes comptables

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July 5, 2013

International Accounting Standards Board
30 Cannon Street, 1st Floor
London EC4M 6XH
United Kingdom

Dear Sirs:

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

This letter is the response of the Canadian Accounting Standards Board (AcSB) to the Exposure Draft, *Financial Instruments: Expected Credit Losses,* issued in March, 2013.

The AcSB is Canada's national accounting standard setting body, which has adopted a strategy of importing IFRSs into Canada for publicly accountable enterprises. The AcSB consists of members from a variety of backgrounds, including financial statement users, preparers, auditors and academics. Additional information about the AcSB can be found at www.frascanada.ca.

The views expressed in this letter take into account comments from individual members of the AcSB and its staff. However, they do not necessarily represent a common view of the AcSB, its committees or staff. Formal positions of the AcSB are developed only through due process.

We recognize the pressure to improve the financial asset impairment accounting standard as a result of the global credit crisis and the ongoing effects of global credit concerns. We think it is important to keep in mind that changing accounting standards may not have a direct or immediate effect on credit underwriting procedures. Improved accounting standards should focus on the relevant circumstances that need to be factored into the measurement of provisions for credit losses.

We are concerned with a proposed accounting standard that focuses so heavily on one industry – financial services. Systemic deficiencies in underwriting and capital adequacy are best left to regulatory bodies. Accounting standards should not be a substitute for prudential regulation. Nevertheless, we appreciate the effort that has gone into attempting to resolve this somewhat intractable problem and support the IASB in its goal of producing a high quality standard as soon as possible. Accordingly, we are prepared to support the proposed standard, subject to concerns articulated below. We think that the IASB has put forward a standard that reflects a reasonable compromise approach focused on reporting adequate provisions when there are concerns about collecting full contractual cash flows, without requiring recognition of full lifetime expected credit losses at inception.

We think it is essential that the IASB and FASB converge their requirements for recognizing and measuring impairment. Converged guidance on this topic is critical to well-functioning global capital markets. Divergence would also impose a significant operational burden on reporting entities that are cross-listed on US exchanges or required to report to US regulators using US GAAP results for subsidiaries. Those circumstances would require maintenance of two accounting models by affected entities, which would not be helpful to stakeholders.

We have concerns with certain aspects of the Exposure Draft proposals. We agree that impairment of financial assets should be recognized on the basis of expected losses but disagree with recognizing credit losses on initial recognition of a financial asset. There is no conceptual basis for recognizing day one losses on assets priced at market and initially measured at fair value, given that initial fair value reflects expected credit losses. Day one loss recognition falls short of a fully faithful representation of the substance of the asset. It also results in a pattern of income recognition over time that does not provide a fully faithful representation of the effect of the asset on the reporting entity's operating results. We therefore view the 12-month expected credit loss model for stage 1 assets as a practical expedient to minimize recognition of day one losses. We think that a careful reassessment of an entity's assets at each reporting date, considering both the probability of default and expected resulting losses, should be sufficient to provide adequate allowances for impairment. We encourage the IASB to ensure that the final standard incorporates this principle.

We would prefer an impairment model that is based on absolute levels of credit risk rather than relative changes in risk. We do not agree that a change in the probability of a default should result in a different allowance model than a change in the estimate of loss given default. A negative change in either should result in a proportional change in the allowance for credit loss. We do not see the logic in reporting a different allowance for two assets with similar terms and conditions and the same current credit rating on the basis of different initial credit ratings. Users have told us that they are interested in credit migration but that they expect to see changes in credit allowances that are commensurate with the change in risk.

We think that the provision for credit losses should be based on an assessment of the credit quality of the portfolio of financial assets that are not measured at fair value through profit or loss at the reporting date. We think that measurement of the loss allowance should reflect the nature and term of the asset. It would be helpful for the standard to state a principle to be applied rather than prescribing a method of calculating the allowance that implies an effort possibly disproportionate to the nature of an entity's credit exposures. The model that is presented as a requirement in the standard might be more appropriate as an example of application of an expected loss impairment recognition and measurement principle to larger portfolios of homogeneous loans. Although not precluded, it might be more appropriate to calculate an allowance for doubtful trade receivables on a matrix based on past experience and expectations about conditions that would change historical experience. This ability to apply the most appropriate model to a group of assets should not be relegated to the Basis for Conclusions.

During our outreach activities, many smaller financial institutions and non-financial entities with significant long-term receivables or investment portfolios have expressed concern about the costs to adapt risk management and financial reporting processes and systems. Our largest financial institutions are also concerned about the nature and extent of systems modifications they would need to operationalize the proposed model. Although they have sophisticated risk management systems and processes, those systems do not always align with financial reporting systems.

Our outreach activities have indicated that the current proposed date of January 1, 2015 for mandatory adoption of IFRS 9 is not feasible. In addition to the guidance proposed in this exposure draft, the hedge accounting portion of the standard has not been finalized. We have been told that at least three years from completion of the standard should be allowed before mandatory adoption of IFRS 9 but that early adoption should be permitted. There are many complexities to the standard that will require at least as much analysis as other new standards expected to be issued in the near future.

In terms of potential disclosure requirements, information about loan pricing and the credit profile of assets held by the reporting entity is best provided by disclosures outlining the distribution of assets by term to maturity or age and risk grade, as appropriate, and by relevant parameters such as industry or geography. Similarly, we think that disclosures about deterioration in the quality of risk-diverse groups of assets and the margins on those assets would provide relevant information. Given the significant degree of management judgment inherent in applying the proposed measurement guidance, it is important to ensure adequate disclosures about the key judgments that most affect the outcome. Empirical evidence indicates that users of financial statements have doubts about how management applies its discretion. Disclosures must enhance users' understanding of how management has applied the proposed guidance or else there will be doubts as to the reliability of the results. We also think that there is an urgent need to proceed with the planned disclosure framework project so that disclosures about expected loan

losses, like all other disclosures, are commensurate with the diverse circumstances of individual reporting entities rather than "one size fits all".

We have included in the Appendix our responses to the questions set out in the Exposure Draft. The responses include suggestions for making the proposal operational by the wide range of entities to which it applies.

We would be pleased to elaborate on our comments in more detail if you require. If so, please contact me or, alternatively, Peter Martin, Director, Accounting Standards (+1 416 204-3276 or email pmartin@cpacanada.ca) or Kate Ward, Principal, Accounting Standards (+1 416 204-3437 or email kward@cpacanada.ca).

Yours truly,

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APPENDIX

Question 1:

(a) Do you agree that an approach that recognises a loss allowance (or provision) at an amount equal to a portion of expected credit losses initially, and lifetime expected credit losses only after significant deterioration in credit quality, will reflect:

(i) the economic link between the pricing of financial instruments and the credit quality at initial recognition; and

(ii) the effects of changes in the credit quality subsequent to initial recognition?

If not, why not and how do you believe the proposed model should be revised?

(b) Do you agree that recognising a loss allowance or provision from initial recognition at an amount equal to lifetime expected credit losses, discounted using the original effective interest rate, does not faithfully represent the underlying economics of financial instruments? If not, why not?

We disagree with recognizing a loss on initial recognition of an asset that is priced at market and initially measured at fair value. We think that such a day one loss falls short of a fully faithful representation of the transaction. Initial expectations of credit risk are reflected in initial fair value measurement. Any allowance recognized at this point affects income measurement both in the period of initial recognition and in subsequent periods. We can see no conceptual basis for recognizing expected credit losses initially.

We agree that a loss allowance should be recognized subsequent to initial recognition if and when credit risk deteriorates. This amount should reflect the probability of default and the expected loss given default based on an entity's past experience and its expectations about future conditions.

Question 2:

(a) Do you agree that recognising a loss allowance (or provision) at an amount equal to 12-month expected credit losses and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation? If not, why not? What alternative would you prefer and why?

As indicated in our cover letter, we believe that the 12-month expected loss guidance reflects a practical compromise and is preferable to lifetime expected loss for these assets from inception. Further, we support a model that results in a provision reflecting the cash flows the entity expects to receive once significant credit deterioration occurs. However, we can see no conceptual support for the 12-month "window" and expect that, like most "bright lines" in accounting standards, it may lead to anomalous results in practice.

We think that the proposal, as presented, will take a considerable amount of cost and time for many entities to implement.

(b) Do you agree that the approach for accounting for expected credit losses proposed in this Exposure Draft achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 ED and the SD (without the foreseeable future floor)?

We refer you to the answer to Question 2 (a) above. Given the comments received at the earlier proposal stages, we believe the current proposal deals with some of the most difficult operational issues raised previously.

(c) Do you think that recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate, achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft?

As noted above, we disagree with recognizing lifetime expected credit losses on assets initially recognized and measured at fair value.

We think that expected losses should be discounted using the original effective interest rate. We acknowledge that there may be some practical difficulties in applying the original effective interest rate. However, we disagree conceptually with the proposed range of flexibility in choosing a discount rate because of the potential for material effects on reported loan loss provisions.

Question 3:

(a) Do you agree with the proposed scope of this Exposure Draft? If not, why not?

We agree that the scope is appropriate for financial institutions.

We are not convinced that the proposed guidance would provide better information about guarantees or other commitments made by entities that are not financial institutions. We do not agree that entities that are not financial intermediaries should recognize loss provisions on commitments, especially if the probability of being required to fund the commitment is low. We think that, if the standard includes that proposed guidance on this issue, the ability to consider the probability of being required to fund the commitment should be specified in the application guidance rather than the illustrative examples. Although we appreciate that distinguishing between standards on the basis of industry is problematic, we are concerned that this proposal has largely ignored the business models and investor needs of entities other than financial institutions. We are also concerned about maintaining consistency with IAS 37 in accounting for commitments generally.

(b) Do you agree that, for financial assets that are mandatorily measured at FVOCI in accordance with the Classification and Measurement ED, the accounting for expected credit losses should be as proposed in this Exposure Draft? Why or why not?

We agree that the same approach should be used to assess impairment of financial assets measured at fair value through other comprehensive income. We think that the practical expedient proposed by the FASB in Proposed Accounting Standards Update, *Financial Instruments – Credit Losses,* has some appeal.

Question 4

Is measuring the loss allowance (or a provision) at an amount equal to 12-month expected credit losses operational? If not, why not and how do you believe the portion recognised from initial recognition should be determined?

Based on our outreach discussions, we think that 12-month expected credit losses can be identified by large financial institutions, which can place reliance on their internal risk management systems. We remain concerned that smaller financial institutions and non-financial entities will have difficulty and may rely solely on historical delinquency-based information.

Question 5:

(a) Do you agree with the proposed requirement to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition? If not, why not and what alternative would you prefer?

We agree, subject to reservations expressed in responses to other questions about the timing and amount of reported loss provisions. We think that it is appropriate to recognize a loan loss provision when the credit risk of an asset increases subsequent to initial recognition.

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

The proposal contains a reasonable amount of guidance on how an entity should determine whether to increase its provision for credit losses. However, we disagree with recognizing day one losses and with basing the allowance on relative changes in credit risk. We think that the guidance could be modified so that it provides more general guidance for assessing changes in credit risk that should precipitate changes in the allowance.

(c) Do you agree that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of a default occurring, rather than changes in expected credit losses (or credit loss given default ('LGD'))? If not, why not and what would you prefer?

If the model is approved more or less as exposed, we agree that, in theory, it is appropriate to exclude changes in the loss given default from the trigger mechanism. However, it is difficult to

envision how the loss given default estimate might significantly increase without an increase in the credit risk of the loan. In practice, we think that an increase in the estimate for loss given default would generally trigger a decrease in credit rating so the distinction might be artificial and difficult to apply. For example, a loan might be assigned a risk rating on the basis of a guarantee or collateral as insurance. If the guarantor fails or the collateral loses value, the loss given default would increase without any change in the obligor's circumstances, i.e., the probability of default. However, it is the credit risk of the loan that is considered, not the obligor, so the increase in the loss given default would also trigger a downgrade for the loan. We think that this should trigger a transfer to lifetime expected losses under the proposed model, if the change is significant.

(d) Do you agree with the proposed operational simplifications, and do they contribute to an appropriate balance between faithful representation and the cost of implementation?

We think that considerable judgement will be necessary to apply the simplification in paragraph 6. The "investment grade" distinction applies to a relatively small population of borrowers. We think that many commercial or consumer entities do not grade their customers. It is rarely possible to estimate when default will occur and the proposed standard does not define exactly what constitutes default. The term "imminent" requires judgement.

We also think that the presumption in paragraph 9 that payments more than 30 days past due constitutes significant deterioration is not, in fact, a reliable indicator of increased credit risk for all types of assets or in all industries. We think that reporting entities should be able to apply market conventions for their industry to determine whether a shorter period or longer period is more appropriate. We are also concerned that the 30 day rebuttable presumption could be read as a "bright line" threshold and therefore we encourage the IASB to emphasize that it has no such intention.

(e) Do you agree with the proposal that the model shall allow the re-establishment of a loss allowance (or a provision) at an amount equal to 12-month expected credit losses if the criteria for the recognition of lifetime expected credit losses are no longer met? If not, why not, and what would you prefer?

We agree. The ability to reverse previously recognized impairment losses when conditions improve is logical.

Question 6:

(a) Do you agree that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) rather than on a gross carrying amount can provide more useful information? If not, why not, and what would you prefer?

We agree that it is difficult to distinguish between payments of principal and payments of interest on a defaulted obligation. However, we think that unwinding the discount on a defaulted asset through interest revenue may provide misleading information to users by distorting their analysis of interest margins. For certain industries, net interest margin is a key metric and

therefore any guidance should be clear and focused on comparability considerations. Some users we have consulted agree with the approach to non-accrual loans proposed by the FASB. We think that non-performing loans and interest recognized thereon should be clearly identifiable through appropriate disclosures.

(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?

We think that the criteria for determining the transition between the three "stages" described in the model are arbitrary and, in the case of transition from Stage 2 to Stage 3, perpetuate one of the main criticisms of the impairment model in IAS 39. If the requirement for objective evidence is a problem in IAS 39, it is unclear why that criterion is expected to be an effective method of identifying non-accrual loans.

As indicated in our response to Question 6(c), we do not think that the basis for calculating interest revenue should change for assets exhibiting objective evidence of impairment. The original effective interest rate should be used.

(c) Do you agree with the proposal that the interest revenue approach shall be symmetrical (ie that the calculation can revert back to a calculation on the gross carrying amount)? Why or why not? If not, what approach would you prefer?

We agree that the interest calculation should revert when the loan is no longer impaired. A reconciliation of gross and allowance balances would help users to determine the effect of such reclassifications.

We are not convinced that a change in discount rate to the effective rate in stage 3 is desirable, if the entity used something other than the effective interest rate while an asset is in stages 1 or 2. We appreciate that the choices proposed in paragraph B29 are intended to relieve the operational burden of the standard, but we think it would be preferable to require use of the effective interest rate at all times to avoid possible subsequent adjustments.

Question 7:

(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

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

(c) What other disclosures do you believe would provide useful information (whether in addition to, or instead of, the proposed disclosures) and why?

We have consulted with a number of preparers and users concerning disclosure issues. Non-financial institution preparers think that the proposed disclosures are excessive given the nature

and extent of their credit exposures. Users think that the reconciliation required in paragraph 35 and the disclosures of the effects of changes in credit risk in paragraphs 42 through 45 will be insufficient to illustrate the effects of credit migration for financial institutions. We refer you to our cover letter in terms of suggested disclosures.

We recommend that the new standard on expected credit losses address in clear terms which of the new disclosures are required in interim financial reports prepared in accordance with IAS 34 and which are to be provided only in annual financial statements.

Question 8:

Do you agree with the proposed treatment of financial assets on which contractual cash flows are modified, and do you believe that it provides useful information? If not, why not and what alternative would you prefer?

We agree.

Question 9:

(a) Do you agree with the proposals on the application of the general model to loan commitment and financial guarantee contracts? Why or why not? If not, what approach would you prefer?

(b) Do you foresee any significant operational challenges that may arise from the proposal to present expected credit losses on financial guarantee contracts or loan commitments as a provision in the statement of financial position? If yes, please explain.

As noted in our response to Question 3(a), we have concerns about the application of the model to loan commitments and financial guarantee contracts held by non-financial institutions.

Question 10:

(a) Do you agree with the proposed simplified approach for trade receivables and lease receivables? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree with the proposed amendments to the measurement on initial recognition of trade receivables with no significant financing component? If not, why not and what would you propose instead?

We disagree with recognizing day one losses. However, if the standard is finalized in its current form, the proposed practical expedients for lease and trade account receivables will make the model easier for entities other than financial institutions to apply. However, as outlined above, we think that the standard should state a principle and provide a range of appropriate models in the application guidance that would more explicitly permit use of matrix-type models for trade receivables.

Question 11:

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

We do not think that it makes sense to differentiate between purchased or originated credit-impaired assets and other assets, assuming that the reporting entity has a single underwriting model. We think that it is most important that credit-impaired assets are clearly distinguished from other financial assets in disclosures and that the entity's policies and procedures for their management and measurement are adequately described.

Effective date and transition – Question 12:

(a) 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.

(b) Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

(c) Do you agree with the proposed relief from restating comparative information on transition? If not, why?

We think that at least three full years from the date of publishing the final standard (including the hedge accounting model) will be necessary to implement the proposed requirements. This time will be necessary to build or revise systems for capturing relevant information and performing the required calculations. Many financial institutions maintain systems for risk management separate from those used for financial reporting and will need to develop bridges between these systems. Accordingly, the earliest mandatory effective date for IFRS 9 should be no earlier than fiscal years beginning on or after January 1, 2017. We think that early adoption should be permitted.

We note that the expected effective date of the new Insurance Contracts standard is 2018. Insurance companies will have difficulty implementing IFRS 9 in advance of changes to the accounting for their policy liabilities. If the financial instruments project continues to experience delays, we think that the Board should consider aligning the effective dates of these two standards.

We agree with the transition requirements and the proposed relief from restating comparative information.

Effects analysis – Question 13:

Do you agree with the IASB's assessment of the effects of the proposals? If not, why not?

We agree that implementation of the model will likely increase credit loss allowances for entities that have not followed a rigorous impairment recognition and measurement process.

We do not agree that the proposed model reflects how many entities manage credit risk. We agree that it will be possible for our largest financial institutions to align their processes with the model, although not without incurring significant costs. However, we do not agree that smaller financial institutions, consumer finance entities, including leasing companies, and commercial entities manage credit risk in the manner expected by the model. Representatives of these types of entities have told us that they estimate allowances on the basis of delinquency and loss experience. Although the exposure draft would permit use of provision matrices for trade receivables, many smaller lenders also provision on the basis of delinquency. We think that most entities in our market determine a credit loss provision with a view to the future but that few attempt to calculate default probabilities systematically.