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IFRS® Standards
SMEIG Q&A

IFRS for SMEs® Standard, Section 12, Issue 1

Accounting for financial guarantee contracts in individual or separate financial statements of issuer

Questions and answers (Q&As) are published by the SME Implementation Group (SMEIG), which assists the International Accounting Standards Board (Board) in supporting implementation of the *IFRS for SMEs* Standard.

The Q&As provide non-mandatory and timely guidance on specific accounting questions raised by entities implementing the *IFRS for SMEs* Standard and by other interested parties. All Q&As issued by the SMEIG will be considered by the Board at its next review of the Standard. At that time, the Board will consider whether to incorporate any of the Q&A guidance in the *IFRS for SMEs* Standard.

Issue

A reporting entity prepares its financial statements applying the *IFRS for SMEs* Standard. The reporting entity guarantees repayment of a loan from a bank to another entity (a financial guarantee contract). An example of where this might commonly arise is when both entities are under common control. How does the reporting entity account for the financial guarantee contract issued to the bank in its separate or individual financial statements?

Response

The reporting entity shall account for the financial guarantee contract by applying the requirements in Section 12 *Other Financial Instrument Issues*—unless the reporting entity chooses to apply the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (as permitted by paragraphs 11.2(b) and 12.2(b) of the *IFRS for SMEs* Standard).

Financial guarantee contracts frequently have characteristics commonly associated with insurance contracts. The accounting treatment outlined in this Q&A should not be assumed to apply to other types of insurance contracts.

Basis for Conclusions

BC1 The appropriate accounting treatment for financial guarantee contracts issued by an entity was initially raised with the SMEIG through the example of a parent entity issuing a financial guarantee contract on behalf of its subsidiary. However, in discussing the issue, the SMEIG concluded that the accounting treatment would also apply to any other case of an entity issuing a financial guarantee contract on behalf of another entity, with the parent-subsidiary case provided as an example.

BC2 The SMEIG was informed of two views on how to apply the *IFRS for SMEs* Standard to financial guarantee contracts issued by a parent entity in that parent entity's separate financial statements:

(a) View 1—the parent entity should account for the financial guarantee contract issued in accordance with Section 21 *Provisions and Contingencies*. Those supporting this view applied the accounting policy hierarchy in paragraphs 10.4–10.6 of Section 10 *Accounting Policies, Estimates and Errors* because they question whether the *IFRS for SMEs* Standard has specific requirements for accounting for financial guarantee contracts.

(b) View 2—the parent entity should account for the financial guarantee contract issued in accordance with Section 12. Those supporting this view treat the financial guarantee contract issued as a financial liability in the scope of Section 11 *Basic Financial Instruments* and Section 12.

The SMEIG concluded that View 2 is the required accounting under the *IFRS for SMEs* Standard. The SMEIG also noted that an entity might issue a financial guarantee contract on behalf of another entity in other circumstances, and that, in such cases, the same accounting treatment should be applied to accounting for the financial guarantee contract in the issuing entity's individual or separate financial statements.

BC3 The *IFRS for SMEs* Standard does not define financial guarantee contracts. In developing this Q&A, the SMEIG considered the definition in full IFRS Standards. Full IFRS Standards[1] define a 'financial guarantee contract' as 'a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.' The *IFRS for SMEs* Standard defines a financial instrument as a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity (paragraph 11.3). The financial guarantee contract issued by the reporting entity is a contractual right of the bank to receive cash from the reporting entity and a contractual obligation of the reporting entity to pay cash to the bank if the other entity defaults. Consequently, the contract is a financial asset of the bank and a financial liability of the reporting entity. The financial guarantee contract is therefore covered by the requirements for accounting for financial instruments in the *IFRS for SMEs* Standard.

BC4 Section 11 applies to basic financial instruments while Section 12 applies to other, more complex financial instruments and transactions. Because the financial guarantee contract is contingent on a future unknown event, the criterion that there are no conditional returns or repayment provisions in paragraph 11.9(d) is not satisfied. Therefore, the financial guarantee contract does not constitute a basic financial instrument as described in paragraph 11.8 because the reporting entity's financial liability does not satisfy all the conditions in paragraph 11.9. Thus, the reporting entity shall account for the financial guarantee contract in accordance with Section 12.

1 See Appendix A of IFRS 4 *Insurance Contracts* and Appendix A of IFRS 9 *Financial Instruments*.

BC5 Section 12 applies to all financial instruments apart from the exceptions listed in paragraph 12.3. One of these exceptions is rights under insurance contracts (paragraph 12.3(d)). A financial guarantee contract meets the definition of an insurance contract in the glossary of the *IFRS for SMEs* Standard. However, because the exception in paragraph 12.3(d) applies only to rights under insurance contracts (financial assets) and not to obligations under insurance contracts (financial liabilities), the financial guarantee contract issued by the reporting entity is in the scope of Section 12.

BC6 Except in limited cases, Section 12 of the *IFRS for SMEs* Standard requires all financial assets and financial liabilities in its scope to be measured at fair value with changes in fair value recognised in profit and loss. The SMEIG think the conclusion reached in this Q&A is the correct interpretation of the current requirements in the *IFRS for SMEs* Standard. However, several respondents to the draft Q&A expressed concern about the complexity of the accounting treatment for financial guarantee contracts under the *IFRS for SMEs* Standard, particularly for intragroup financial guarantee contracts. Some respondents noted that it was more complex than the accounting treatment in full IFRS Standards. In this sense, the SMEIG will recommend that the Board considers whether to revisit the accounting treatment for financial guarantee contracts at the next review of the *IFRS for SMEs* Standard with a view to providing measurement relief.

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