IFRS

STAFF PAPER

September 2019

IASB® Meeting

Project	**Comprehensive review of the *IFRS for SMEs*® Standard**
Paper topic	Questions and answers developed by the SME Implementation Group (SMEIG Q&A)

CONTACT(S)	Yousouf Hansye	ykhansye@ifrs.org	+44 (0) 20 7246 6470
	Michelle Sansom	msansom@ifrs.org	+44 (0) 20 7246 6963

Purpose

1. At this meeting we are asking Board members if the Request for Information that will be issued as part of the 2019 Comprehensive Review of the *IFRS for SMEs* Standard (2019 Review) should seek views on incorporating into the *IFRS for SMEs* Standard questions and answers (Q&As) developed by the SME Implementation Group (SMEIG).

2. The objective of the Request for Information is to obtain evidence that will assist the Board in deciding whether and how to develop an exposure draft of amendments to the *IFRS for SMEs* Standard.

Background

3. The SMEIG considers questions about applying the *IFRS for SMEs* Standard, decides which questions merit application guidance, reaches a consensus on what that guidance should be and develops the guidance in the form of publicly available Q&As on a timely basis.

4. The Board has previously said it will consider all Q&As published by the SMEIG at each review of the *IFRS for SMEs* Standard to decide whether to incorporate the

Q&As into the *IFRS for SMEs* Standard or in the education materials that support the *IFRS for SMEs* Standard.[1]

5. All Q&As published prior to the issue of the 2015 amendments to the *IFRS for SMEs* Standard have been incorporated either into the *IFRS for SMEs* Standard or in the educational materials.

6. Since the 2015 amendments to the *IFRS for SMEs* Standard were issued by the Board, the SMEIG has published one Q&A on *Accounting for financial guarantee contracts in individual or separate financial statements of issuer* (Q&A 2017/12.1) and one draft Q&A on *Application of the undue cost or effort exemption for investment property on transition to the* IFRS for SMEs *Standard*.

Summary of staff recommendation

7. The staff recommend that the Board seek views in the Request for Information on:
   (a) adding the definition of financial guarantee contracts that is in IFRS 9 *Financial Instruments* to the *IFRS for SMEs* Standard; and
   (b) aligning the requirements for financial guarantee contracts that an entity has issued with IFRS 9.

Structure of the paper

8. This paper is structured as follows:
   (a) Overview of Q&A 2017/12.1 (paragraphs 9–11);
   (b) Staff analysis (paragraphs 12–26);
   (c) Staff recommendation (paragraphs 27–28);
   (d) Question for the Board;

[1] *IFRS for SMEs* Standard paragraph BC227.

(e) Appendix A— SMEIG Q&A, December 2017—Section 12, Issue 1: *Accounting for financial guarantee contracts in individual or separate financial statements of issuer*;

(f) Appendix B—Extract of paragraph 12.8 of the *IFRS for SMEs* Standard.

Overview of Q&A 2017/12.1

9. Q&A 2017/12.1 addresses the accounting used by an entity applying the *IFRS for SMEs* Standard when it guarantees repayment of a loan from a bank to another entity—that is, when the entity issues a financial guarantee contract to a bank.

10. Q&A 2017/12.1 provides that the entity shall account for issued financial guarantee contracts by applying the requirements in Section 12, unless the reporting entity chooses[2] to apply the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement*.

11. Applying Section 12, a financial guarantee contract is measured initially[3], and at the end of each reporting period[4], at fair value with changes in fair value recognised in profit or loss.

Staff analysis

Definition of financial guarantee contracts

12. The *IFRS for SMEs* Standard does not define financial guarantee contracts. In developing the Q&A, the SMEIG considered the definition in full IFRS Standards.

13. Appendix A of IFRS 9 defines 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

[2] As permitted by paragraphs 11.2(b) and 12.2(b) of the *IFRS for SMEs* Standard.

[3] *IFRS for SMEs* Standard, paragraph 12.7.

[4] *IFRS for SMEs* Standard, paragraph 12.8.

a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

14. The staff recommends that the IFRS 9 definition should be added to the *IFRS for SMEs* Standard as part of aligning the *IFRS for SMEs* Standard with IFRS 9. The staff sees no reason to amend the definition.

Measurement of financial guarantee contracts

15. The staff notes that applying Section 12, a financial guarantee contract that an entity has issued is measured initially, and at the end of each reporting period, at fair value with changes in fair value recognised in profit or loss.

16. Many respondents to the draft Q&A expressed concern about the complexity of the accounting treatment for issued financial guarantee contracts applying Section 12 of the *IFRS for SMEs* Standard, particularly for intragroup financial guarantee contracts. Some of these respondents said requiring issued financial guarantee contracts to be measured at fair value each year is more complex than the accounting treatment in full IFRS Standards. Consequently, the SMEIG recommended that the Board revisit the accounting treatment for financial guarantee contracts during the 2019 Review with a view to providing measurement relief.

17. The staff has considered three possible solutions for providing measurement relief.

Approach 1: Incorporate Financial Guarantee Contracts issued into Section 21

18. The staff consulted the SMEIG in January 2019 as part of its preparations for developing the Request for Information. One SMEIG member supported accounting for issued financial guarantee contracts applying Section 21 *Provisions and Contingencies* of the *IFRS for SMEs* Standard.

19. Applying Section 21 on initial recognition the financial guarantee contract would be measured at the best estimate of the amount required to settle the obligation at the reporting date[5]. This measurement would be updated at subsequent reporting dates.[6]

20. The staff does not support the SMEIG member's recommendation because it would result in further misalignment with full IFRS Standards.

Approach 2: Introduce an undue cost or effort exemption for issued financial guarantee contracts

21. A possible relief is to extend the undue cost or effort exemption to issued financial guarantee contracts if an entity determines the fair value cannot be estimated. However, staff does not recommend this relief because it is not clear which alternative accounting an entity would apply if the fair value of a financial guarantee contract cannot be estimated.

22. The staff thinks that an entity could revert and apply Section 21, if the fair value cannot be estimated. Applying Section 21, an entity would (as explained above) measure the financial guarantee contract at the best estimate of the amount required to settle the obligation. As stated above the staff does not think this would constitute a measurement relief and would not align with full IFRS Standards.

23. Alternative to Section 21, an entity may provide only disclosures about the issued financial guarantee contract if it determines it cannot make a reliable estimate. The staff does not consider disclosure-only is appropriate because no liability would be recognised.

24. Consequently, the staff does not support extending the undue cost or effort exemption because of the absence of feasible alternatives if the exemption is applied.

Approach 3: Align with IFRS 9 requirements

25. Applying IFRS 9, a financial guarantee contract that an entity has issued is measured initially at fair value and thereafter at the higher of (a) the amount of any expected

[5] *IFRS for SMEs* Standard, paragraph 21.7.

[6] *IFRS for SMEs* Standard, paragraph 21.11.

credit losses that would have been recognised had the entity made the loan itself (rather than guaranteeing the loan repayments) and (b) the amount initially recognised less, when appropriate, the cumulative amount of income recognised applying the principles of IFRS 15 *Revenue from Contracts with Customers*.

26. Staff thinks aligning with the IFRS 9 requirements addresses the SMEIG recommendations in the Basis for Conclusions of the Q&A to add measurement relief (see Appendix A). However, staff notes that financial guarantee contracts would not meet the conditions of a basic financial instrument.

Staff recommendation

27. The staff recommends that the Board consults in the Request for Information on:

    (a) adding the definition of financial guarantee contracts that is in IFRS 9 to the *IFRS for SMEs* Standard; and

    (b) aligning the requirements for issued financial guarantee contracts in the *IFRS for SMEs* Standard with IFRS 9 by incorporating the Q&A into Section 12 and adding a third exception into paragraph 12.8.

28. The staff recommendation takes into consideration:

    (a) that incorporating Q&A 2017/12.1 is consistent with the Board's previous decision that Q&As should be incorporated into the *IFRS for SMEs* Standard and/or the IFRS Foundation's educational material and then deleted.

    (b) the SMEIG's recommendation that the Board revisits the accounting treatment for financial guarantee contracts with a view to providing measurement relief.

    (c) in September 2018 the staff consulted the SMEIG about SMEs' use of financial guarantee contracts and issues they encounter in practice. The majority of SMEIG members said SMEs in their jurisdictions commonly issue financial guarantee contracts. Therefore, the guidance on accounting for issued financial guarantee contracts is important for entities applying the *IFRS for SMEs* Standard.

Question for the Board

Question
Does the Board agree with the staff recommendation to seek views in the Request for Information on: (a) including the IFRS 9 definition of financial guarantee contracts in the *IFRS for SMEs* Standard; and (b) aligning the requirements for issued financial guarantee contracts with IFRS 9.

Appendix A—SMEIG Q&A, December 2017—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[7] 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

[7] See Appendix A of IFRS 4 *Insurance Contracts* and Appendix A of IFRS 9 *Financial Instruments*.

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.

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.

Appendix B—Extract of paragraph 12.8 of the *IFRS for SMEs* Standard

At the end of each **reporting period**, an entity shall measure all financial instruments within the scope of Section 12 at fair value and recognise changes in fair value in **profit or loss**, except as follows:

(a) some changes in the fair value of **hedging instruments** in a designated hedging relationship are required to be recognised in **other comprehensive income** by paragraph 12.23; and

(b) **equity** instruments that are not **publicly traded** and whose fair value cannot otherwise be measured reliably without undue cost or effort and contracts linked to such instruments that, if exercised, will result in delivery of such instruments, shall be measured at cost less impairment.