

STAFF PAPER

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IASB® meeting

Project	Second Comprehensive Review of the <i>IFRS for SMEs</i> ® Standard		
Paper topic	Towards an Exposure Draft—IFRS 9 <i>Financial Instruments</i> (classification and measurement of financial assets)		
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Introduction

1. This paper discusses whether and how to propose amending the *IFRS for SMEs* Standard for IFRS 9 *Financial Instruments* (classification and measurement requirements for financial assets).

Purpose of the paper

2. The purpose of this paper is to ask the International Accounting Standards Board (Board) to:
 - (a) consider feedback on the Request for Information *Comprehensive Review of the IFRS for SMEs Standard*, published in January 2020, and the recommendations of the SME Implementation Group (SMEIG) on supplementing the list of examples in Section 11 *Basic Financial Instruments* of the *IFRS for SMEs* Standard with a principle for classifying financial assets based on their contractual cash flow characteristics; and
 - (b) decide whether to propose to supplement the list of examples with such a principle.

Summary of staff recommendations

3. The staff recommend the Board propose an amendment to the *IFRS for SMEs* Standard to supplement the list of examples in Section 11 of the *IFRS for SMEs* Standard with a principle for classifying financial assets based on their contractual cash flow characteristics.

Structure of the paper

4. This paper is structured as follows:
 - (a) background (see paragraphs 6–11 of this paper);
 - (b) question in the Request for Information (see paragraphs 12–13 of this paper);
 - (c) feedback and SMEIG recommendations (see paragraphs 14–30 of this paper);
 - (d) staff analysis applying the alignment principles:
 - (i) relevance to SMEs (see paragraphs 31–36 of this paper);
 - (ii) simplicity (see paragraphs 37–40 of this paper);
 - (iii) faithful representation (see paragraphs 41–42 of this paper); and
 - (iv) costs and benefits consideration (see paragraphs 43–46 of this paper).
 - (e) staff recommendation and question for the Board (see paragraph 47 of this paper).

5. Appendix A to this paper sets out the Board’s rationale in the Request for Information for asking views on supplementing the list of examples in Section 11 with a principle for classifying financial assets based on their contractual cash flow characteristics.

Background

Requirements in the IFRS for SMEs Standard

6. The *IFRS for SMEs* Standard includes requirements for financial instruments in Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*. These sections were developed when IAS 39 *Financial Instruments: Recognition and Measurement* was effective and before the Board issued IFRS 9. However, there are significant differences between Sections 11 and IAS 39.¹
7. Section 11 requires financial instruments that are basic financial instruments to be measured as follows:
 - (a) debt instruments that satisfy the conditions set out in paragraphs 11.8(b) and 11.9 of Section 11 are measured at amortised cost.
 - (b) some commitments to receive a loan are measured at cost less impairment.
 - (c) investments in non-convertible preference shares and non-puttable ordinary shares or preference shares that are publicly traded or whose fair value can otherwise be measured reliably without undue cost or effort are measured at fair value through profit or loss. All other such investments are measured at cost less impairment.
8. Financial instruments that do not qualify as basic financial instruments are within the scope of Section 12 and are measured at fair value through profit or loss.
9. Section 11 provides a list of examples of basic financial instruments as well as the conditions a debt instrument must satisfy to qualify (that is to be classified) as a basic financial instrument. Section 11 also provides examples of debt instruments that do not satisfy the conditions and therefore do not qualify as basic financial instruments.

¹ An overview of Sections 11 and 12 and of differences between these sections and IAS 39 is provided in Appendix B to [Agenda Paper 30C for the June 2019 Board meeting](#).

10. IFRS 9 applies a principle-based approach to the classification of financial assets. Applying IFRS 9, when an entity initially recognises a financial asset, its classification is based on:
- (a) the contractual cash flow characteristics of the financial asset; and
 - (b) the business model for managing the financial assets.²

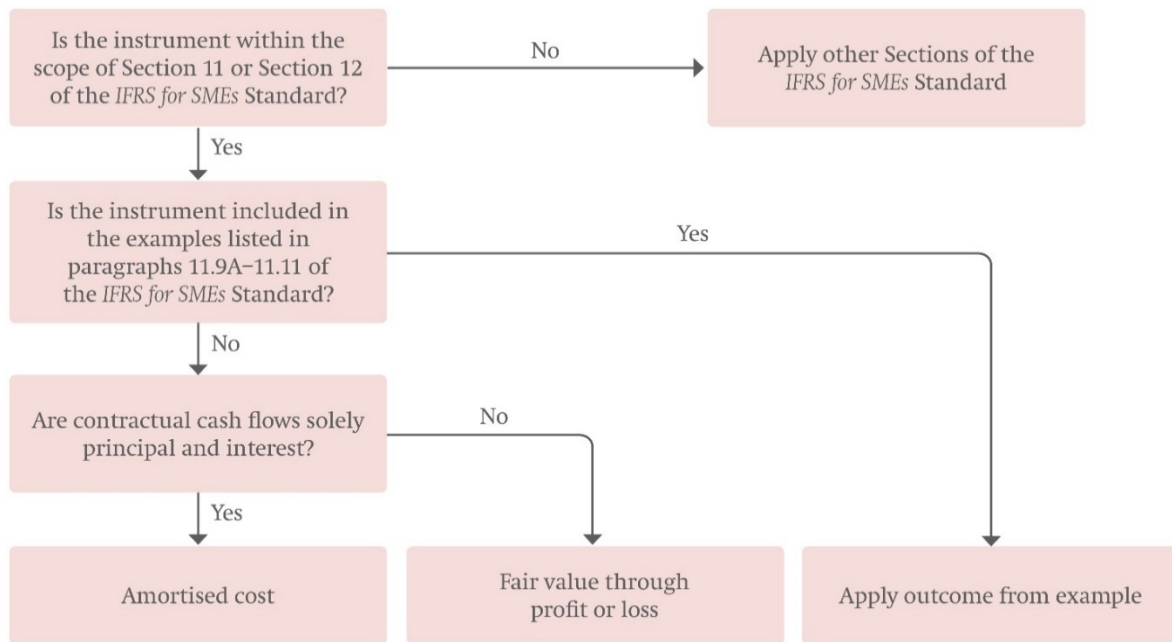
Request for information

11. The Request for Information sought views on supplementing the list of examples in Section 11 with a principle for classifying financial assets. The Board's objective was to be helpful in the circumstance in which a financial asset does not match the characteristics described in any of the examples in Section 11. The Board's rationale is set out in paragraphs B27–B34 of Appendix B of the Request for Information and reproduced in Appendix A to this paper.

Question in the Request for Information

12. Question S3A of the Request for Information asked for views on supplementing the list of examples in Section 11 with a principle for classifying financial assets based on their contractual cash flow characteristics.
13. The flowchart on the next page outlines the process for classifying financial assets to determine how they would be measured if such a principle and the simplifications discussed in paragraph 37 of this paper were included in the *IFRS for SMEs* Standard.

² Paragraph 4.1.1 of IFRS 9.



Feedback and SMEIG recommendations

Methods for obtaining feedback

14. Stakeholders provided feedback on Question S3A of the Request for Information in several ways, including:
 - (a) comment letters;
 - (b) an online survey; and
 - (c) outreach events.
15. The SMEIG met on 4–5 February 2021 to discuss the feedback from stakeholders on the Request for Information and develop recommendations to enable the Board to decide on whether and if so how to align the *IFRS for SMEs* Standard with IFRS 9.

Overall feedback

16. Overall feedback on the Request for Information supported supplementing the list of examples in Section 11 with a principle for classifying financial assets based on their contractual cash flow characteristics.

Feedback from comment letters

17. Many respondents who commented on the classification of financial assets said that a principle for classifying financial assets based on their contractual cash flow characteristics would be helpful for entities to classify a financial asset in the circumstance in which the asset does not match the characteristics described in existing examples.
18. A small number of respondents said it is premature to consider whether the *IFRS for SMEs* Standard should be updated to align with IFRS 9 given that IFRS 9 is subject to a post-implementation review.
19. A small number of respondents agreed the Board should not introduce in Section 11 as assessment of the entity’s business model for the purpose of classifying and measuring financial assets.
20. In contrast, a small number of respondents expressed the view that Section 11 should incorporate a simplified business model test so that, for example:
 - (a) basic financial assets held for the purpose of trading or selling in the ordinary course of business are required to be measured at fair value through profit or loss; and
 - (a) basic financial assets are permitted (but not required) to be measured at fair value through profit or loss in cases in which this measurement is more representative of the entity's business model.
21. Most of those respondents supported not introducing the option to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument. For example, one national standard-setter said:

...there is no compelling reason to introduce this option in the Standard, in particular if some stakeholders are concerned that the fair value changes accumulated in other comprehensive income will not be reclassified subsequently to profit or loss.
22. In contrast, a small number of respondents expressed the view that the option should be introduced because, for example, it is just an option, so an entity can choose whether it is practicable, relevant or appropriate to use it.

23. One accounting firm supported replacing the list of examples in Section 11 with a principle-based approach for classifying financial instruments and suggested simplified disclosure requirements rather than introducing the disclosure principles and disclosure requirements of IFRS 7 *Financial Instruments: Disclosures* and IFRS 13 *Fair Value Measurement* in the *IFRS for SMEs* Standard. The disclosure requirements will be discussed in a future paper.
24. A small number of respondents, while agreeing with supplementing the list of examples in Section 11 with a principle for classifying financial assets based on their contractual cash flow characteristics, suggested that the principle should not undermine the conditions in paragraph 11.9 and the examples in paragraphs 11.8 and 11.9A–11.11 of Section 11.

Feedback from online survey and outreach events

25. Most respondents to the online survey and participants in outreach events agreed with supplementing the list of examples in Section 11 with a principle for classifying financial assets based on their contractual cash flow characteristics. The main reason provided by respondents to the survey is that the approach would assist application of the Standard. For example, one respondent said:

“a principle is better than a list of examples which is not exhaustive.”
26. Some respondents to the online survey did not support supplementing the list of examples in Section 11 with a principle for classifying financial assets based on their contractual cash flow characteristics because they were concerned that the principle could introduce complexity in the *IFRS for SMEs* Standard.
27. A small number of participants in outreach events were concerned about the implementation costs of introducing such a principle.

SMEIG recommendations³

28. SMEIG members generally agreed with the staff’s preliminary thoughts that the feedback provides evidence for the Board to supplement the list of examples in Section 11 with a principle for classifying financial assets based on their contractual cash flow characteristics.
29. SMEIG members said:
- (a) such a principle would provide a clear rationale for the classification of financial assets and would assist entities in the circumstance in which a financial asset does not match the characteristics in any of the examples in Section 11;
 - (b) the approach is easy to understand and simpler than aligning with the classification requirements of IFRS 9; and
 - (c) introducing such a principle will be a significant help to users of financial statements in understanding the financial instruments in the statement of financial position.
30. Other views expressed by a small number of SMEIG members included:
- (a) concerns from one SMEIG member about the complexity of introducing contractual cash flow characteristics because, in his view, this would result in greater use of fair value than Section 11 requires.
 - (b) a suggestion from another SMEIG member to introduce an option (that is, permit but not require) to use the fair value through profit or loss classification for basic financial instruments subject to a simplified business model test when this classification is more representative of the entity’s business model. For example, if an entity holds a debt instrument for the

³ The Report on the SMEIG meeting, held via remote participation, on 4–5 February 2021 can be accessed [here](#).

purpose of trading that debt, it should be permitted to use the fair value through profit or loss classification.

- (c) consistent with a small number of respondents (see paragraph 18 of this paper) a suggestion from another SMEIG member to wait until the post-implementation review of IFRS 9 is complete before considering alignment.

Staff analysis applying the alignment principles

Relevance to SMEs

31. As discussed in paragraph 33 of the Request of Information, relevance to SMEs is determined by assessing whether the problem addressed by a new requirement would make a difference in the decisions of users of financial statements prepared applying the *IFRS for SMEs* Standard.
32. As discussed in paragraphs 6–9 of this paper, the *IFRS for SMEs* Standard already includes classification requirements for financial assets. The Board’s objective in seeking views in the Request for Information was to be helpful in the circumstance in which a financial asset does not match the characteristics described in the examples in Section 11. The supplementary principle will improve the consistency for the classification of financial assets, in the circumstance an entity holds a financial asset not included in the list of examples.
33. Supplementing the list of examples with a principle based on contractual cash flow characteristics will not change the existing examples as the principle would only apply in the circumstances in which debt instruments do not meet the conditions in paragraph 11.9 and the examples in paragraphs 11.8 and 11.9A–11.11 of Section 11.

34. The staff think that introducing the contractual cash flow characteristics as a supplementary principle will bring several benefits to users and preparers of financial statements applying the *IFRS for SMEs* Standard, including:
- (a) in the circumstance in which a financial asset does not match the characteristics described in the examples in Section 11, the principle provides a clear rationale for measuring financial assets at either amortised cost or fair value that would help users understand the financial reporting of financial assets; and
 - (b) providing a basis for classifying financial assets at amortised cost based on their contractual cash flow characteristics will ensure the faithful representation of the instrument’s characteristics and will provide relevant information on an entity’s performance.
35. Accordingly, the staff think that introducing the contractual cash flow characteristics will result in relevant information and ease application for entities applying the *IFRS for SMEs* Standard.
36. The staff do not think the Board should wait until it completes the post-implementation review of IFRS 9 before introducing the supplementary principle as this would delay the benefits to users and preparers of financial statements applying the *IFRS for SMEs* Standard.

Simplicity

37. As discussed in paragraphs 19 and 21 of this paper, the feedback on the Request for Information provides support for the Board to confirm the following simplifications for the classification of financial assets applying the supplementary principle:
- (a) not introducing the requirement to determine how financial assets should be classified and measured on the basis of the entity’s business model for managing the financial asset; and
 - (b) not introducing the option to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument.

38. As discussed in paragraphs 20 of this paper, a small number of respondents suggested:
- (a) the Board consider introducing a simplified business model test in the *IFRS for SMEs* Standard to require or permit entities to measure basic financial instruments within the scope of Section 11 at fair value through profit or loss; and
 - (b) permit entities to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument.
39. The staff do not think the business model test is needed in the *IFRS for SMEs* Standard because it is not common for entities applying the Standard to hold financial assets based on complex business models. In addition, if the Board introduce a simplified business model test in the *IFRS for SMEs* Standard, it would need to address the timing and accounting for reclassification when an entity changes the business model within which it manages a financial asset. Because reclassification is extremely rare, such requirement will be rarely applied.
40. Consequently, the staff do not recommend the Board consider the alternative suggestions in paragraph 38 of this paper on the basis of simplicity. This is consistent with feedback from SME preparers from outreach meetings—ie the need to keep the *IFRS for SMEs* Standard simple to avoid imposing burden on entities applying the Standard.

Faithful representation

41. As discussed in paragraph B33 of the Request for Information the Board took the view that the simplifications discussed in paragraph 37 of this paper would not impede faithful representation. This is because not introducing the business model assessment is unlikely to significantly impact the classification for financial assets held by entities applying the *IFRS for SMEs* Standard. The feedback on the Request for Information does not include any new information that would require the Board to reconsider this view.

42. Accordingly, the staff believe the Board's view, that the right trade-off is achieved between relevance and simplicity through not introducing the business model assessment without impeding faithful representation, still holds.

Costs and benefits consideration

43. The staff acknowledge that the initial application of the supplementary principle for classifying financial assets based on their contractual cash flow characteristics could involve initial application costs for entities applying the supplementary principle in the circumstance in which a financial asset does not match the characteristics described in the examples in Section 11. However, feedback on the Request for Information mentioned that the vast majority of SMEs are likely to have financial assets within the scope of the existing examples in Section 11. Consequently, the staff think introducing the supplementary principle will make Section 11 easier to apply in the circumstances and entity has a financial instrument that does not match the existing examples.
44. In addition, the simplifications discussed in paragraph 37 of this paper, particularly not introducing the business model assessment for classification of financial assets, will reduce application costs for preparers.
45. The staff note that SMEIG members said the supplementary principle will bring benefit to users of financial statements prepared applying the *IFRS for SMEs* Standard because it will be a significant help to them in understanding the financial instruments in the statement of financial position (see paragraph 29(c) of this paper).
46. Consequently, the staff do not foresee any significant application costs for SMEs related to applying the supplementary principle, and think the benefits to preparers and users of SME financial statements would outweigh the costs of introducing the supplementary principle in the *IFRS for SMEs* Standard.

Staff recommendation and question for the Board

47. In the light of the feedback from comment letters, online survey and outreach events and the SMEIG recommendations, the staff recommend the Board propose an amendment to the *IFRS for SMEs* Standard to supplement the list of examples in Section 11 with a principle for classifying financial assets based on their contractual cash flow characteristics.

Question for the Board

Does the Board agree with the staff recommendation to propose an amendment to the *IFRS for SMEs* Standard to supplement the list of examples in Section 11 with a principle for classifying financial assets based on their contractual cash flow characteristics?

Appendix A—Board rationale in the Request for Information for asking views on supplementing the list of examples in Section 11 with a principle for classifying financial assets based on their contractual cash flow characteristics

- A1. Section 11 provides a list of examples to help entities classify financial assets, while IFRS 9 requires that entities apply a principle-based approach. The Board is seeking views on aligning the classification requirements of Section 11 with those requirements in IFRS 9 by supplementing the list of examples in paragraphs 11.9A–11.11 of the *IFRS for SMEs* Standard with a principle based on the ‘solely payments of principal and interest’ (SPPI) test.
- A2. The Board concluded that supplementing the list of examples in Section 11 with a principle would provide a clear rationale for classifying financial assets and thereby measuring them either at amortised cost or fair value and that a principle based on the SPPI test would assist entities in the circumstance in which a financial asset does not match the characteristics in any of the examples.
- A3. In supplementing the list of examples in Section 11 with a principle based on the contractual cash flow characteristics, the Board decided it should simplify the classification and measurement of financial assets by:
- (a) removing the requirement to determine how financial assets should be classified and measured on the basis of the entity’s business model for managing the financial asset; and
 - (b) removing the option to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument.
- A4. The Board takes the view that these simplifications would not impede faithful representation because removing the business model assessment is unlikely to significantly affect the classification of financial assets held by entities applying the *IFRS for SMEs* Standard.

A5. Figure 1 outlines the process for classifying financial assets to determine how they would be measured if a principle (aligned with IFRS 9) was added to the list of examples in Section 11 and the simplifications in paragraph B32 [paragraph A3 of this appendix were included.

Figure 1—Measuring financial assets applying the *IFRS for SMEs* Standard

