STAFF PAPER

March 2022

IASB® meeting

Project	**Second Comprehensive Review of the *IFRS for SMEs*® Standard**
Paper topic	Towards an Exposure Draft—IFRS 9 *Financial Instruments* (issued financial guarantee contracts)
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Introduction

1. This paper recommends adding requirements for issued financial guarantee contracts to the *IFRS for SMEs* Standard to align with IFRS 9 *Financial Instruments*, with simplifications.

2. In this paper, the term SMEs refers to small and medium-sized entities that are eligible to apply the *IFRS for SMEs* Standard.

3. Paragraphs 8–29 of this paper were presented to the IASB at its December 2021 meeting in Agenda Paper 30E *Towards an Exposure Draft—IFRS 9 Financial Instruments (issued financial guarantee contracts)*. They are being brought back to this meeting as the IASB decided to defer its discussion on measurement of issued financial guarantee contracts pending a tentative decision on aligning the *IFRS for SMEs* Standard with the expected credit loss model in IFRS 9.

Purpose of the paper

4. The purpose of this paper is to ask the IASB 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 possible amendments to the requirements for issued financial guarantee contracts in Section 12 *Other Financial Instrument Issues* of the Standard (Question S3E of the Request for Information); and

   (b) continue its discussion from December 2021 on possible amendments to the requirements for issued financial guarantee contracts in Section 12 of the Standard.

Summary of staff recommendations

5. The staff recommend the IASB propose amendments to the *IFRS for SMEs* Standard to require the issuer of a financial guarantee contract to initially measure the contract at the premium received (plus the present value of any future premium payments payable), which may be nil, and subsequently measure it at the higher of:

   (a) the expected credit losses; and

   (b) the amount initially recognised, if any, amortised on a straight-line basis over the life of the guarantee.

6. The amount in paragraph 5(a) of this paper would be measured consistently with the expected credit loss model the IASB tentatively decided on at its February 2022 meeting.

Structure of the paper

7. This paper is structured as follows:
   (a) background (paragraphs 8–14 of this paper);
   (b) question in the Request for Information (paragraphs 15–16 of this paper);
   (c) feedback and SMEIG recommendations (paragraphs 17–29 of this paper);
   (d) IASB discussions so far (paragraphs 30–32 of this paper)
   (e) staff analysis (paragraphs 33–46 of this paper); and
   (f) staff recommendation and question for the IASB (paragraph 47 of this paper).

Background

Overview of Q&A 2017/12.1 on issued financial guarantee contracts

8. In 2017, the SMEIG developed Q&A 2017/12.1 *Accounting for financial guarantee contracts in individual or separate financial statements of the issuer* because it was informed of two different views on how to apply the *IFRS for SMEs* Standard to financial guarantee contracts issued by a parent entity:
   (a) View 1—the parent entity should apply Section 21 *Provisions and Contingencies* to issued financial guarantee contracts. 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 apply Section 12 to issued financial guarantee contracts. Those supporting this view consider the issued financial guarantee contract to be a financial liability within the scope of Section 12.

9. Q&A 2017/12.1 clarifies that the issued financial guarantee contract is a financial liability of the entity and so the requirements in Section 12 apply (see paragraphs 11–12 of this paper) unless the entity chooses the option in Section 11 *Basic Financial*

Instruments and Section 12 to apply the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (fallback to IAS 39).

10. In developing the Q&A, the SMEIG applied the definition in IFRS 9, as the *IFRS for SMEs* Standard does not define financial guarantee contracts. Furthermore, in the Basis for Conclusions accompanying Q&A 2017/12.1, the SMEIG recommended that the IASB revisit the accounting treatment for issued financial guarantee contracts during the second comprehensive review with a view to providing measurement relief. The SMEIG made this recommendation based on feedback that measuring issued financial guarantee contracts applying Section 12 is more complex than the accounting requirements in full IFRS Accounting Standards.

Accounting for issued financial guarantee contracts

Applying Section 12 of the IFRS for SMEs *Standard*

11. The *IFRS for SMEs* Standard does not have specific requirements for financial guarantees. However, an issued financial guarantee contract meets the definition of a financial liability within the scope of Section 12.

12. Applying Section 12, a financial guarantee contract issued by an entity is measured initially, and at the end of each reporting period, at fair value with changes in fair value recognised in profit or loss.

Applying IFRS 9

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

14. Applying IFRS 9, a financial guarantee contract issued by an entity is measured initially at fair value and thereafter at the higher of:

(a) provision for expected credit losses;[1] and

(b) the amount initially recognised less the cumulative amount of income recognised, when appropriate, applying the principles of IFRS 15 *Revenue from Contracts with Customers*.

Question in the Request for Information

15. Question S3E of the Request for Information asked for views on the following amendments to the requirements in the *IFRS for SMEs* Standard:

(a) adding the definition of a financial guarantee contract from IFRS 9; and

(b) aligning the requirements for issued financial guarantee contracts with IFRS 9.

16. In reaching its decision to seek views on aligning the accounting requirements for issued guarantee contracts with IFRS 9, the IASB considered asking stakeholders for views on alternative accounting requirements, such as applying the requirements of Section 21 of the *IFRS for SMEs* Standard. The IASB decided seeking views on alternative accounting requirements would be inconsistent with its previous decision to ask for views on aligning Sections 11 and 12 with IFRS 9.[2]

[1] In developing IFRS 9, the IASB retained the accounting in IAS 39 for financial guarantee contracts, except to reflect the new impairment requirements.
[2] Paragraph B45 of the Request for Information.

Feedback on the Request for Information

Overall feedback

17. Feedback on the Request for Information generally supported introducing the definition of a financial guarantee contract from IFRS 9 into the *IFRS for SMEs* Standard.

18. There was some support for aligning the requirements for issued financial guarantee contracts with IFRS 9. However, there were also concerns that the IFRS 9 requirements are too complex for SMEs and simplifications should be considered.

Feedback from comment letters

19. Most respondents who commented on the requirements for issued financial guarantee contracts supported introducing the definition of a financial guarantee contract from IFRS 9 into the *IFRS for SMEs* Standard because they:

    (a) note that issued financial guarantee contracts are common for SMEs, particularly intragroup guarantees;

    (b) support aligning important definitions with IFRS Accounting Standards in general; and

    (c) believe such a definition would provide clarity about the accounting for issued financial guarantee contracts.

20. A small number of respondents said that introducing the definition of a financial guarantee contract from IFRS 9 into the *IFRS for SMEs* Standard is unnecessary and would not meet the relevance principle.

21. Respondents expressed mixed views about aligning the requirements in the *IFRS for SMEs* Standard for issued financial guarantee contracts with IFRS 9.

22. Some respondents support aligning the requirements in the *IFRS for SMEs* Standard for issued financial guarantee contracts with IFRS 9 because they believe the requirements in IFRS 9 are simpler than applying Section 12. Some respondents said

the requirements should be aligned with IFRS 9, but with some simplifications (for example, to the requirement to determine the amount of any expected credit losses) or permitting the use of an undue cost or effort exemption.

23. In contrast, some respondents do not support aligning the requirements in the *IFRS for SMEs* Standard for issued financial guarantee contracts with IFRS 9 because in their view these requirements are too complex for SMEs. Most of these respondents suggested that an SME should apply the requirements of Section 21 to its financial guarantee contracts, which they believe are simpler than the requirements for issued financial guarantee contracts in IFRS 9 and sufficient for financial reporting by SMEs.

24. Some respondents said the type of financial guarantees commonly issued by SMEs are related party financial guarantees (eg a parent provides a financial guarantee to its subsidiary) and obtaining fair value information for the purposes of Section 12 or IFRS 9 would be difficult.

Feedback from the online survey and outreach events

25. Most respondents to the online survey and participants in outreach events supported adding the definition of a financial guarantee contract from IFRS 9 and aligning the requirements for issued financial guarantee contracts with IFRS 9.

SMEIG recommendation[3]

26. The SMEIG met on 4–5 February 2021 to discuss the feedback from stakeholders on the Request for Information and develop recommendations for the IASB to decide on amendments to the *IFRS for SMEs* Standard.

27. Most SMEIG members said the feedback provided evidence for the IASB to introduce the definition of a financial guarantee contract from IFRS 9 into the *IFRS for SMEs* Standard.

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

28. Some SMEIG members said entities should apply Section 21 to issued financial guarantee contracts because the requirements in Section 21 are simpler for SMEs.

29. One SMEIG member suggested aligning the requirements in the *IFRS for SMEs* Standard for issued financial guarantee contracts with IFRS 9.

IASB discussions so far

30. At its March 2021 meeting, the IASB confirmed its alignment approach, which treats alignment with full IFRS Accounting Standards as the starting point for developing the *IFRS for SMEs* Standard, and applies the principles of relevance to SMEs, simplicity and faithful representation, including the assessment of costs and benefits, in determining whether and how that alignment should take place (see Agenda Paper 30 *Cover paper*).

31. At its December 2021 meeting:

    (a) the IASB considered the feedback to the Request for Information that some SMEs issue financial guarantee contracts, particularly intragroup financial guarantees. For these SMEs, alignment with IFRS 9 would significantly change the measurement of those contracts and improve information for users of their financial statements.

    (b) therefore, the IASB generally agreed that the relevance principle is met and tentatively decided to propose to add the definition of a 'financial guarantee contract' from IFRS 9 (see paragraph 13 of this paper). However, it deferred its discussion on the measurement requirements pending its February 2022 discussions on aligning the *IFRS for SMEs* Standard with the expected credit loss model in IFRS 9.

32. As the IASB has already assessed that the relevance principle is met, the staff analysis in this paper only considers whether the IFRS 9 requirements for issued financial guarantee contracts would satisfy the principles of simplicity and faithful representation, and the assessment of costs and benefits.[4]

[4] The staff analysis of the relevance principle for issued financial guarantees is in paragraphs 30–32 of [Agenda Paper 30E of the December 2021 IASB meeting].

Staff analysis

Simplicity

33. Applying the principle of simplicity involves looking at the IFRS 9 requirements for issued financial guarantee contracts, given they have satisfied the relevance condition, and then assessing what simplifications are appropriate.

34. The IASB has received feedback from the SMEIG and respondents to the Request for Information that accounting for issued financial guarantee contracts applying Section 12 is more complex than applying the requirements in IFRS 9. Therefore, aligning the requirements for issued financial guarantee contracts with IFRS 9 would be expected to provide a simplification. Nevertheless, feedback indicates that the requirements for issued financial guarantee contracts in IFRS 9 may still be too complex for SMEs, particularly for related party financial guarantee contracts.

35. Therefore, the staff have considered how the requirements in IFRS 9 might be simplified for SMEs. The staff have not considered alternative requirements, such as including issued financial guarantee contracts in the scope of Section 21 *Provisions and Contingencies* of the *IFRS for SMEs* Standard because:

    (a) an issued financial guarantee contract meets the definition of a financial liability and there is no logical basis for excluding it from Sections 11 and 12; and

    (b) such alternative requirements would be inconsistent with the IASB's alignment approach to align Sections 11 and 12 with IFRS 9, with simplifications if needed.

How could the measurement requirements in IFRS 9 be simplified?

36. Applying IFRS 9, a financial guarantee contract issued by an entity is measured initially at fair value and thereafter at the higher of:

    (a) provision for expected credit losses; and

(b) the amount initially recognised less the cumulative amount of income recognised, when appropriate, applying the principles of IFRS 15.

37. The staff think any proposed simplification would need to be consistent with the IASB's February 2022 tentative decision to propose to align Section 11 for financial assets measured at amortised cost (other than trade receivables and contract assets within the scope of Section 23 *Revenue*) with the expected credit loss model. The staff also think the following simplifications to the requirements in paragraph 36 of this paper should be considered:

   (a) *Initial measurement.* An issued financial guarantee contract could be initially measured at the premium received (plus the present value of any future premium payments payable). The staff developed this simplification to:

      (i) be consistent with the requirement in paragraph 11.13 of the *IFRS for SMEs* Standard that a basic financial asset or liability is measured initially at the transaction price unless the arrangement constitutes, in effect, a financing transaction; and

      (ii) respond to feedback that determining the fair value of an issued financial guarantee contract is difficult, particularly for related party contracts.

   (b) *Subsequent measurement*. The staff think the IASB could simplify the wording of the IFRS 9 requirements in paragraph 36(b) of this paper by referring to 'the amount initially recognised, if any, amortised on a straight-line basis over the life of the guarantee'. The staff think in most cases, the outcome of applying this wording would be similar to the outcome from applying paragraph 36(b) of this paper for the types of financial guarantee contracts commonly issued by SMEs (although the amount initially recognised applying the simplification in paragraph 37 of this paper may not be fair value). Furthermore, it would be easy to apply and understand by SMEs and users of their financial statements.

38. Applying these simplifications, the staff have developed the following approach for the measurement requirements for issued financial guarantee contracts for SMEs:

> A financial guarantee contract issued by an entity is measured initially at the premium received (plus the present value of any future premium payments payable), which may be nil, and thereafter at higher of:
>
> (a) the expected credit losses;[5] and
>
> (b) the amount initially recognised, if any, amortised on a straight-line basis over the life of the guarantee.

39. To be consistent with the IASB's February 2022 tentative decision to align Section 11 for financial assets measured at amortised cost (other than trade receivables and contract assets within the scope of Section 23 *Revenue*) with the expected credit loss model, the following paragraph would also be included in the *IFRS for SMEs* Standard (taken from Appendix B to Agenda Paper 30A *Towards an exposure draft—IFRS 9 Financial Instruments (Impairment of Financial Assets)* of the February 2022 IASB meeting and aligned with paragraph B5.5.32 of IFRS 9):

> For a financial guarantee contract, the entity is required to make payments only in the event of a default by the debtor in accordance with the terms of the instrument that is guaranteed. Accordingly, cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity expects to receive from the holder, the debtor or any other party. If the asset is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfalls for the asset subject to the guarantee.[6]

[5] Paragraph 11.X2 from Appendix B states that expected credit losses are a probability-weighted estimate of credit losses (ie the present value of all cash shortfalls) over the expected life of the financial instrument.
[6] Paragraph 11.X6 from Appendix B to Agenda Paper 30A of the February 2022 IASB meeting.

Who should apply the approach in paragraph 38 of this paper?

40. The staff think the approach in paragraph 38 of this paper is appropriate for all financial guarantee contracts issued by SMEs. Nevertheless, if the IASB disagrees, it could consider providing the approach as an exemption from the IFRS 9 requirements only in the following circumstances:

   (a) for intragroup or related party financial guarantee contracts—feedback indicates that most financial guarantees issued by SMEs are related party financial guarantees and that fair value can be difficult to measure; and/or

   (b) if application of the IFRS 9 requirements results in undue cost or effort (undue cost or effort exemption).

Faithful representation

41. The principle of faithful representation is intended to help the IASB assess whether financial statements prepared applying the *IFRS for SMEs* Standard would faithfully represent the substance of economic phenomena in words and numbers. Simplifications that would result in financial statements that do not meet this criterion could damage the quality of information reported to users.

42. Feedback indicates that the type of financial guarantee contracts commonly issued by SMEs are related party financial guarantees. For these contracts, the staff observe that often there is no premium received or receivable, and hence the financial guarantee contract would be initially recognised at nil. Nevertheless, in this case, the subsequent measurement requirements would ensure that the financial guarantee contract would be measured in the statement of financial position at an amount equal to the provision for expected credit losses at each reporting date. The staff think this outcome would faithfully represent the financial liability.

43. The staff also note that straight-line amortisation of the amount initially recognised applying paragraph 38(b) of this paper may not always reflect the recognition of revenue applying IFRS 15 (see paragraph 36(b) of this paper). However, the staff think this simplification is unlikely to impede faithful representation because, as noted above, the amount initially recognised applying paragraph 38 of this paper may often

be nil (for related party financial guarantee contracts issued for no consideration) meaning that the amount recognised under paragraph 38(b) of this paper would also be nil.

44. The staff also think the recommended approach in paragraph 38 of this paper would reduce costs to SMEs without significantly reducing the usefulness of information provided to users of SME financial statements.

Advice from SMEIG members

45. Given that this is a specialised area, the staff asked SMEIG members for volunteers with practical experience or expertise in application of IFRS 9’s expected credit loss model or accounting for financial guarantees to help the staff develop possible amendments to the *IFRS for SMEs* Standard. These SMEIG members were unanimously supportive of applying the recommended approach in paragraph 38 of this paper to all financial guarantee contracts issued by SMEs.

46. All SMEIG members were given the opportunity to comment on the staff’s approach once developed and were generally supportive of the approach in paragraph 38 of this paper. However, one SMEIG member noted that the approach assumes the guarantee is provided equally over time (amortisation on a straight-line basis, rather than applying IFRS 15). This member agreed this treatment may be reasonable given the assumptions about guarantees typically issued by SMEs but suggested allowing amortisation on another basis if this better reflects the way the guarantee is provided.

Staff recommendation and question for the IASB

47. The staff recommend the IASB propose amendments to the *IFRS for SMEs* Standard to require an SMEs to initially measure a financial guarantee contract it issued at the premium received (plus the present value of any future premium payments payable), which may be nil, and thereafter at higher of:

    (a) the expected credit losses; and

    (b) the amount initially recognised, if any, amortised on a straight-line basis over the life of the guarantee.

The amounts in paragraph 47(a) of this paper would be measured consistently with the IASB's tentative decision to align the *IFRS for SMEs* Standard with the expected credit loss model discussed in Agenda Paper 30A of the February 2022 IASB meeting.

Question for the IASB
Does the IASB agree with the staff recommendation in paragraph 47 of this paper?