STAFF PAPER

October 2021

IASB® meeting

Project	**Second Comprehensive Review of the *IFRS for SMEs*® Standard**
Paper topic	Towards an Exposure Draft—IFRS 9 *Financial Instruments* ('fallback' to full IFRS recognition and measurement requirements)

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Introduction

1. This paper discusses whether the option to apply the recognition and measurement requirements in full IFRS Standards for financial instruments in Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instrument Issues* of the *IFRS for SMEs* Standard (the 'fallback' to full IFRS Standards) should be removed upon consideration of alignment of those sections with IFRS 9 *Financial Instruments*.[1]

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

Purpose of the paper

3. 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

[1] The existing fallback to full IFRS Standards in the *IFRS for SMEs* Standard is a fallback to an old IFRS Standard, IAS 39 *Financial Instruments: Recognition and Measurement.*

recommendations of the SME Implementation Group (SMEIG) on the fallback to full IFRS Standards for financial instruments (Question S3D of the Request for Information); and

(b) decide whether to remove the fallback to full IFRS Standards completely from Sections 11 and 12 of the *IFRS for SMEs* Standard during this review.

4. Before considering whether the existing option to apply the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (fallback to IAS 39) should be updated to an option to apply the recognition and measurement requirements of IFRS 9 (fallback to IFRS 9), the staff think the Board should first consider whether the fallback to IFRS Standards for financial instruments can be removed completely (ie no fallback to either IAS 39 or IFRS 9) because Sections 11 and 12 will be considered for alignment with IFRS 9 during this review. By 'considered for alignment with IFRS 9' the staff mean application of the principles in the Board's alignment approach to the requirements in IFRS 9 (see paragraph 5 of Agenda Paper 30). For example, if the Board applies its alignment approach to the hedge accounting requirements in IFRS 9, and decides, applying those principles, not to change the existing requirements in Section 12 (as recommended by the staff in Agenda Paper 30B), this would still constitute considering alignment with IFRS 9.

5. If the Board disagrees with the staff recommendation that the fallback to full IFRS Standards for financial instruments can be removed completely from Sections 11 and 12 of the *IFRS for SMEs* Standard, the staff will bring a proposal to a future Board meeting regarding whether the existing fallback to IAS 39 should be replaced by a fallback to IFRS 9.

Summary of staff recommendations

6. The staff recommend the Board propose an amendment to the *IFRS for SMEs* Standard to remove the option to apply the recognition and measurement requirements in full IFRS Standards for financial instruments (fallback to full IFRS

Standards) in Sections 11 and 12 of the *IFRS for SMEs* Standard (ie remove the existing fallback to IAS 39, without replacing it with a fallback to IFRS 9).

7. This recommendation is conditional on the Board considering alignment of Sections 11 and 12 with IFRS 9 through applying the Board's alignment approach during this review.

Structure of the paper

8. This paper is structured as follows:

   (a) background (paragraphs 9–11 of this paper);

   (b) question in the Request for Information (paragraph 12 of this paper);

   (c) feedback on the Request for Information (paragraphs 13–17 of this paper);

   (d) SMEIG recommendations (paragraphs 18–20 of this paper);

   (e) staff analysis (paragraphs 21–25 of this paper); and

   (f) staff recommendation and question for the Board (paragraphs 26–27 of this paper).

Background

9. Sections 11 and 12 of the *IFRS for SMEs* Standard contain the requirements for financial instruments. The *IFRS for SMEs* Standard currently permits entities to apply either:

   (a) the requirements of both Sections 11 and 12 of the *IFRS for SMEs* Standard in full; or

   (b) the recognition and measurement requirements of IAS 39 and the disclosure requirements of Sections 11 and 12 (referred to as the 'fallback' to IAS 39).[2]

[2] For accounting periods beginning on or after 1 January 2018, SMEs choosing the fallback to IAS 39 apply the version of IAS 39 that applied immediately prior to the effective date of IFRS 9.

10. The option to apply the recognition and measurement requirements of IAS 39 is the only fallback to full IFRS Standards in the *IFRS for SMEs* Standard.[3] Paragraph BC106 of the Basis for Conclusions on the *IFRS for SMEs* Standard explains the Board's original reasoning for permitting the fallback to IAS 39:

> BC106 The *IFRS for SMEs* gives SMEs a choice of following Sections 11 and 12 or IAS 39 in accounting for all of their financial instruments. The Board's reasons for proposing that choice in this case are as follows:
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> (a) Although Sections 11 and 12 are a simpler approach to accounting for financial instruments than IAS 39, some of the simplifications involve eliminating options that are available to companies with public accountability under IAS 39, for instance:
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> (i) the fair value option.
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> (ii) available-for-sale classification and the available-for-sale option.
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> (iii) held-to-maturity classification.
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> (iv) a continuing involvement approach to derecognition (ie partial derecognition).
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> (v) the use of hedge accounting for hedges other than the four specific types identified in paragraph BC101(c).
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> The Board is currently reconsidering IAS 39 in its entirety and concluded that SMEs should be permitted to have the same accounting policy options as in IAS 39 pending completion of the comprehensive IAS 39 project.
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> (b) Because the default category for financial instruments in the scope of Section 12 is fair value through profit and loss under the *IFRS for SMEs*, and cost or amortised cost is permitted only when specified conditions are met, some items measured at cost or amortised cost under IAS 39 because of their nature would be measured at fair value through profit or loss under the *IFRS for SMEs*. Some SMEs might find this added fair valuation burdensome.
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> (c) Sometimes, an entity makes what it views as a 'strategic investment' in equity instruments issued by another entity, with the intention of establishing or maintaining a long-term operating relationship with the entity in which the investment is made. Those entities generally believe that the available-for-sale classification of IAS 39 is appropriate to account for strategic investments. Under the *IFRS for SMEs*, however, these strategic investments would be accounted for either at fair value through profit or loss or at amortised cost. [4]
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> (d) The derecognition provisions of the *IFRS for SMEs* would not result in derecognition for many securitisations and factoring transactions that SMEs may enter into, whereas IAS 39 would result in derecognition.

[3] IAS 39 is an old IFRS Standard that has been superseded by IFRS 9 and so is no longer part of full IFRS Standards. Nevertheless, the staff refer to the fallback to IAS 39 (as well as a possible fallback to IFRS 9) as a fallback to full IFRS Standards for ease of reference in this paper.

[4] IFRS 9 permits an entity to make an irrevocable election at initial recognition to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument that is neither held for trading nor contingent consideration in a business combination (the FVOCI election). This option is not currently available in the *IFRS for SMEs* Standard. The Request for Information did not ask a question about introducing the FVOCI election and feedback did not show support for this election.

11. The Board reconsidered the fallback to IAS 39 during its first comprehensive review of the *IFRS for SMEs* Standard. Paragraph BC217 of the Basis for Conclusions on the *IFRS for SMEs* Standard explains the Board's reasoning for keeping the fallback to IAS 39:

> BC217 Consistently with the primary aim of developing a stand-alone, simplified set of accounting principles for SMEs, the IASB would prefer the fallback to full IFRS to be ultimately removed. However, the IASB decided that the fallback to IAS 39 should be retained until IFRS 9 is considered at a future review for the following reasons:
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> (a) when the *IFRS for SMEs* was issued, the IASB decided that SMEs should be permitted to have the same accounting policy options as in IAS 39 pending completion of the IASB's Financial Instruments project and this reasoning remains valid until IFRS 9 is considered (see paragraph BC106).
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> (b) if entities are currently applying IAS 39, the IASB does not think that it is appropriate to require them to change to Sections 11 and 12 when it is expected that IFRS 9 will be considered at the next review of the *IFRS for SMEs*.
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> (c) the IASB notes that, based on its outreach, most SMEs, except subsidiaries of full IFRS groups, appear to have found the fallback to full IFRS onerous and have chosen to follow Sections 11 and 12 in full. However, without sufficient evidence, the IASB does not think that the fallback to full IFRS should be removed during this comprehensive review.
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> The IASB discussed introducing a fallback to IFRS 9 as a further (third) option. This was rejected because the IASB considered that the potential confusion created by having three alternative models outweighed any potential benefits.

Question in the Request for Information

12. Question S3D of the Request for Information asked respondents:

    (a) whether they are aware of entities that opt to apply the fallback to IAS 39 (to obtain evidence on how frequently the fallback is used); and

    (b) for their views on changing the reference to IAS 39 to permit an entity to apply the recognition and measurement requirements of IFRS 9 and the disclosure requirements of Sections 11 and 12 (ie updating the fallback to IAS 39 to a fallback to IFRS 9).

Feedback on the Request for Information

Overall feedback

13. Feedback generally supported updating the fallback from IAS 39 to IFRS 9. That said, most respondents are not aware of SMEs using the fallback to IAS 39.

Feedback from comment letters

14. Most respondents to Question S3D are not aware of SMEs choosing the fallback to IAS 39. Some respondents noted that it appears to be used only by SMEs that are subsidiaries of entities applying full IFRS Standards and captive insurance entities. However, one respondent noted the fallback to IAS 39 is used by some SMEs that use accounting outsource providers, which serve both SMEs and companies applying IFRS Standards.

15. Many respondents supported updating the fallback from IAS 39 to a fallback to IFRS 9. Reasons included:

    (a) IFRS 9 includes updated concepts and introduces improvements over IAS 39;

    (b) to be consistent with an approach of alignment with IFRS Standards; and

    (c) IAS 39 is no longer being maintained by the Board and will be withdrawn under full IFRS Standards once IFRS 17 *Insurance Contracts* is effective.[5]

16. Some respondents said that if Sections 11 and 12 are aligned with IFRS 9 during this review then the fallback to full IFRS Standards could be removed completely. Reasons included:

    (a) the option is rarely used by SMEs;

    (b) the option affects comparability between SMEs; and

[5] IFRS 9 provides a temporary exemption that permits insurers to apply IAS 39 rather than IFRS 9 for annual periods beginning before 1 January 2023.

(c) the *IFRS for SMEs* Standard should be maintained as a simplified standalone Standard and, therefore, it should not have any reference to any specific IFRS Standard.

Feedback from the online survey and outreach events

17. Feedback from the online survey and outreach events was generally consistent with the feedback from comment letters.

SMEIG recommendations[6]

18. 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 *Financial Instruments.*

19. SMEIG members generally agreed that the feedback provides evidence for the Board to change the fallback from IAS 39 to IFRS 9.

20. One SMEIG member asked whether the Board would consider removing the fallback completely given the reasons for having a fallback to IAS 39 in the Standard (see paragraphs 10–11 of this paper).

Staff analysis

21. The Board's primary aim when developing the *IFRS for SMEs* Standard was to provide a stand-alone, simplified set of accounting principles for entities that do not have public accountability and that typically have less complex transactions, limited resources to apply full IFRS Standards and that operate in circumstances in which comparability with their listed peers is not an important consideration (see paragraph BC187 of the Basis for Conclusions on the *IFRS for SMEs* Standard). The Board's

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

project plan for this second comprehensive review is to update the *IFRS for SMEs* Standard by applying the Board's alignment approach to incorporate the principles and requirements of IFRS Standards, without changing the original aim of the *IFRS for SMEs* Standard. Consequently, the Board is not reconsidering the aim of the *IFRS for SMEs* Standard.

22. During the first comprehensive review of the *IFRS for SMEs* Standard, the Board noted that consistent with this primary aim, it would prefer the only fallback to full IFRS Standards in the *IFRS for SMEs* Standard to be removed. However, the Board decided to retain the fallback to IAS 39 pending consideration of IFRS 9 at a future review and evidence on how frequently the fallback is used by SMEs (see paragraph 11 of this paper). Feedback on the Request for Information indicates that most respondents are not aware of SMEs opting to apply the fallback to IAS 39. Furthermore, during this second comprehensive review the Board is considering alignment of Sections 11 and 12 with IFRS 9. Therefore, the reasons for retaining the fallback to IAS 39 in paragraph 11 of this paper are no longer applicable. Furthermore, following the Board's project plan for this second comprehensive review (see paragraph 21 of this paper), the aim would be to update Sections 11 and 12 by applying the Board's alignment approach to incorporate the principles and requirements of IFRS 9. In doing so these sections would be expected to be complete, rather than needing a fallback to IFRS 9.

23. Some hold the view that the fallback to full IFRS Standards for financial instruments should be maintained because it would enable Sections 11 and 12 to be further simplified for typical SMEs, whilst enabling SMEs with more complex financial instruments to apply full IFRS recognition and measurement requirements. However, others are of the view that the same is true for other sections of the *IFRS for SMEs* Standard and there does not appear to be a good reason for maintaining indefinitely a single exception in the *IFRS for SMEs* Standard for financial instruments, which permits SMEs to use full IFRS recognition and measurement.

24. Furthermore, as observed above, removal of the fallback to full IFRS Standards would be consistent with the primary aim of the *IFRS for SMEs* Standard and the Board's previous deliberations (paragraphs 10–11 of this paper).

25. The staff have the following further observations about the fallback to full IFRS Standards for financial instruments in Sections 11 and 12:

(a) although most respondents supported updating the fallback from IAS 39 to IFRS 9, most respondents explained this is because IFRS 9 is an improved Standard or because IAS 39 is being withdrawn. Furthermore, most of these respondents are not aware of SMEs electing to apply the fallback to IAS 39. Therefore, whilst feedback indicates there is more support for a fallback to IFRS 9 than a fallback to IAS 39, it does not clearly indicate support for keeping a fallback to full IFRS Standards.

(b) accounting policy options increase the complexity of the Standard, reduce comparability between SMEs, and generally increase costs for both preparers and users of financial statements. Some SMEs may not have sufficient expertise or resources to apply recognition and measurement requirements of full IFRS Standards (IAS 39 or IFRS 9) properly and may produce poor quality financial information if they choose to apply the fallback.

(c) the *IFRS for SMEs* Standard is intended to be a self-contained, standalone Standard. Therefore, any options or requirements considered appropriate for SMEs should be incorporated in the *IFRS for SMEs* Standard, not via a cross-reference to full IFRS Standards. The Board initially proposed twenty-three other fallbacks to full IFRS Standards in the 2007 Exposure Draft, but in response to feedback the Board decided to remove them to make the final Standard standalone and limit complex options (paragraph BC34(a)–(b) of the Basis for Conclusions on the *IFRS for SMEs* Standard).

(d) if SMEs have the capability or need to apply complex accounting requirements for financial instruments, they can apply full IFRS Standards, rather than the *IFRS for SMEs* Standard.

(e) based on feedback, few SMEs use the fallback to IAS 39 except subsidiaries that produce full IFRS information for consolidation purposes. The Board has recently published an Exposure Draft that would permit eligible subsidiaries to apply IFRS Standards with a reduced set of disclosure requirements. Those subsidiaries may find that the proposed new Standard better caters for their needs than applying the *IFRS for SMEs* Standard together with the fallback to full IFRS Standards for recognition and measurement of financial instruments.

Staff recommendation and question for the Board

26. The staff recommend the Board propose an amendment to the *IFRS for SMEs* Standard to remove the option to apply the recognition and measurement requirements in full IFRS Standards for financial instruments (fallback to full IFRS Standards) in Sections 11 and 12 of the *IFRS for SMEs* Standard (ie remove the existing fallback to IAS 39, without replacing it with a fallback to IFRS 9).

27. This recommendation is conditional on the Board considering alignment of Sections 11 and 12 with IFRS 9 through applying the Board's alignment approach during this comprehensive review.

Question for the Board
Does the Board agree with the staff recommendation?