STAFF PAPER

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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 Section 12 *Other Financial Instrument Issues* of the *IFRS for SMEs* Standard to align with IFRS 9 *Financial Instruments*, with simplifications. The paper builds on the discussion in Agenda Paper 30D *IFRS 9* Financial Instruments *(impairment of financial assets)* and it is prepared under the assumption that the International Accounting Standards Board (IASB) proposes to replace the existing incurred loss model for financial assets in the *IFRS for SMEs* Standard with an expected credit loss model.

   If the IASB decides to retain the incurred loss model during its discussion on Agenda Paper 30D, the staff will bring a revised proposal on accounting for issued financial guarantee contracts to a future meeting.

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 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 of the Standard (Question S3E of the Request for Information); and

   (b) decide whether to propose adding requirements in Section 12 for issued financial guarantee contracts that are aligned with IFRS 9, with simplifications.

Summary of staff recommendations

4. The staff recommend the IASB propose amendments to the *IFRS for SMEs* Standard to:

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

   (b) 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:

      (i) the amount of expected payments to reimburse the holder less any amounts that the entity expects to be reimbursed; and

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

5. The amounts in paragraph 4(b)(i) of this paper would be measured consistently with any expected credit loss approach the IASB decides to follow as discussed in Agenda Paper 30D.

Structure of the paper

6. This paper is structured as follows:

   (a) background (see paragraphs 7–13 of this paper);

   (b) question in the Request for Information (see paragraphs 14–15 of this paper);

   (c) feedback and SMEIG recommendations (see paragraphs 16–28 of this paper);

   (d) staff analysis (see paragraphs 29–45 of this paper); and

   (e) staff recommendation and question for the IASB (see paragraphs 46–47 of this paper).

Background

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

7. 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 company:

   (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.

8. 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 10-11 of this paper) unless the entity chooses the option in Sections 11 and 12 to apply

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

9. 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 Standards.

Accounting for issued financial guarantee contracts

Applying Section 12 of the IFRS for SMEs *Standard*

10. 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.

11. 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

12. 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.'

13. 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

14. 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.

15. 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 Section 11 and Section 12 with IFRS 9.[2]

Feedback on the 2020 Request for Information

Overall feedback

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

[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.

17. 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

18. 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 intra-group guarantees;
    (b) support aligning important definitions with full IFRS Standards in general; and
    (c) believe such a definition would provide clarity about the accounting for issued financial guarantee contracts.
19. 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.
20. Respondents expressed mixed views about aligning the requirements in the *IFRS for SMEs* Standard for issued financial guarantee contracts with IFRS 9.
21. 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. A small number of 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 the undue cost or effort exemption.
22. 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 entity 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.

23. Some respondents noted that the type of financial guarantees commonly issued by SMEs are related party financial guarantees (e.g., 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

24. 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]

25. 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.

26. 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.

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

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

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

Staff analysis

29. At its May 2021 meeting, the IASB confirmed its alignment approach which treats alignment with IFRS 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). The staff have considered these principles below in developing the staff recommendation.

Relevance to SMEs

30. Relevance to SMEs requires consideration of whether SMEs issue financial guarantee contracts and, if they do, whether alignment with IFRS 9's requirements for issued financial guarantees would make a difference in the decisions of users of financial statements prepared applying the *IFRS for SMEs* Standard.

31. During development of the Request for Information, the staff consulted the SMEIG and the majority of SMEIG members said SMEs in their jurisdictions commonly issue financial guarantee contracts, particularly intra-group guarantees. Feedback from respondents to the Request for Information also confirmed that SMEs commonly issue financial guarantee contracts, particularly intra-group guarantees. One SMEIG member observed that financial guarantee contracts are usually issued by 'larger' SMEs, particularly when a group structure exists—for small SMEs, financial institutions often ask for personal guarantees from the directors or shareholders rather than from the SME itself**.**

32. Aligning with the IFRS 9 requirements would significantly change the measurement of issued financial guarantee contracts from that described in paragraph 11 of this paper and is expected to improve information for users of the financial statements. Therefore, the staff think the relevance principle is met to align with the IFRS 9 requirements for issued financial guarantee contracts.

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.

Definition of a financial guarantee contract

34. Feedback generally supported adding the definition of a financial guarantee contract from IFRS 9. Some respondents noted that adding this definition would provide clarity about the requirements for financial guarantee contracts. The SMEIG also referred to the definition in IFRS 9 when developing Q&A 2017/12.1 (see paragraph 9). Therefore, the staff think adding IFRS 9's definition of a financial guarantee contract, without simplification, into the *IFRS for SMEs* Standard would provide helpful clarification for SMEs.

Measurement requirements for issued financial guarantee contracts

35. The IASB has received feedback from the SMEIG and respondents to the Request for Information that accounting for 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 intragroup financial guarantee contracts.

36. 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?

37. 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 *Revenue from Contracts with Customers*.

38. The staff think any proposed simplification would need to be consistent with any expected credit loss approach the IASB decides to follow as discussed in Agenda Paper 30D. The staff also think the following simplifications to the requirements in paragraph 37 should be considered:

    (a) *Initial measurement:* The 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 proposal to:

        (i) be consistent with the requirement in paragraph 11.13 of the *IFRS for SMEs* Standard that a basic financial asset/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 the issued financial guarantee contract is difficult.

    (b) *Subsequent measurement*. The staff think the IASB could simplify the wording of the IFRS 9 requirements in paragraph 37 as follows:

        (i) for paragraph 37(a), refer to 'the amount of expected payments to reimburse the holder less any amounts that the entity expects to be reimbursed' (ie, the calculation of the estimated cash shortfall) instead of 'provision for expected credit losses' to simplify the drafting.

(ii) for paragraph 37(b), refer 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 37(b) for the types of financial guarantee contracts commonly issued by SMEs (although the amount initially recognised under the staff proposal in paragraph 38(a) may not be fair value). Furthermore, it would be easy to apply and understand by SMEs and users of their financial statement. The staff note that we would ensure that this suggestion is consistent with our proposals for alignment with IFRS 15.

39. Applying these above simplifications, the staff have developed the following proposal:

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 amount of expected payments to reimburse the holder less any amounts that the entity expects to be reimbursed; and

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

The amounts in (a) would be measured consistently with any expected credit loss approach the IASB decides to follow as discussed in Agenda Paper 30D.

Who should apply the proposed approach in paragraph 39?

40. The staff think the proposed approach in paragraph 39 of this paper is appropriate for all financial guarantee contracts issued by SMEs. Nevertheless, if the IASB disagrees, it could consider providing the proposed 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. The staff observe that the premium received or receivable could be nil, for example for an intragroup financial guarantee, and hence the financial guarantee 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. We think this outcome would faithfully represent the financial liability.

43. The staff also think the proposed approach in paragraph 39 would reduce costs to SMEs without significantly reducing the usefulness of information provided to users of SME financial statements.

Advice from SMEIG members

44. 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 staff develop proposals. These SMEIG members were unanimously supportive of applying the proposed approach in paragraph 39 to all financial guarantee contracts issued by SMEs.

45. All SMEIG members were given the opportunity to comment on the staff proposals once developed and were generally supportive of the proposal in paragraph 39. However, one SMEIG member noted that the proposal 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

46. The staff recommend the IASB propose to amend the *IFRS for SMEs* Standard by including the IFRS 9 definition of a financial guarantee contract:

> 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.

47. The staff also recommend that a financial guarantee contract issued by an SME 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 amount of expected payments to reimburse the holder less any amounts that the entity expects to be reimbursed; and

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

The amounts in (a) would be measured consistently with any expected credit loss approach the IASB decides to follow as discussed in Agenda Paper 30D.

Question for the IASB
Does the IASB agree with the staff recommendation in paragraphs 46-47 of this paper?