IFRS® Accounting

Staff paper

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Topic	**Initial consideration**
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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about how an entity, in its separate financial statements, accounts for guarantees that it issues on obligations of its joint venture.

2. The objective of this paper is:

   (a) to provide the Committee with a summary of the matter;

   (b) to present our research and analysis; and

   (c) to ask the Committee whether it agrees with our recommendation not to add a standard-setting project to the work plan.

Structure of this paper

3. This paper includes:

   (a) summary of the submission (paragraphs 5–8);

   (b) findings from information request (paragraphs 9–20);

   (c) staff analysis (paragraphs 21–42); and

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(d) staff recommendation (paragraphs 43–44).

4. There are two appendices to this paper:

(i) Appendix A—suggested wording for the tentative agenda decision; and

(ii) Appendix B—submission.

Summary of the submission

5. An entity (Entity A) issues guarantees on obligations of its joint venture (Entity JV). The submission illustrates these guarantees in three fact patterns as follows:

(a) **Fact Pattern 1**

Entity JV enters into a contract with a customer to deliver services at a specified time in the future. Entity JV enters into another contract with a bank, whereby the bank would provide a guarantee to the customer on behalf of Entity JV. If Entity JV fails to satisfy its contractual obligations to the customer, the bank would:

(i) be required to pay the customer in accordance with the guarantee; and

(ii) have a right to seek reimbursement from Entity JV.

Entity A in turn provides a guarantee to the bank on behalf of Entity JV. If Entity JV is unable to reimburse the bank, the bank will have a right to seek reimbursement from Entity A instead.

(b) **Fact Pattern 2**

Entity JV enters into a contract with a customer to deliver services at a specified time in the future. The contract stipulates that, if Entity JV fails to meet its contractual obligations to the customer as agreed, Entity JV would be liable to pay a penalty to the customer.

Entity A in turn provides a guarantee to the customer on behalf of Entity JV such that:

(i) Entity JV would meet its contractual obligations to the customer as agreed;

(ii) if Entity JV fails to meet its contractual obligations, Entity JV would be liable to pay a penalty to the customer. If Entity JV is unable to pay the penalty, Entity A would pay the penalty instead; and

(iii) Entity A would indemnify the customer against any costs, losses or liabilities associated with the guaranteed obligations.

(c) **Fact Pattern 3**

Entity JV is involved in a construction project. Upon reaching certain milestones during that project, Entity JV is contractually obliged:

(i) to make bonus payments to a third party; and

(ii) to provide loan and equity contributions to the project's consortium.

Entity A provides a guarantee such that if Entity JV fails to meet any of these contractual obligations, Entity A would be required to make payments in respect of those obligations.

6. The submission asks how Entity A, in its separate financial statements, should account for guarantees of the types described above. In particular, the submission asks whether the guarantees are financial guarantee contracts to be accounted for in accordance with IFRS 9 *Financial Instruments* or, if not, which other IFRS Accounting Standards apply to these guarantees.

7. The submission also describes an alternative situation involving the fact patterns whereby, if Entity JV fails to meet its contractual obligations, Entity A:

(a) is immediately liable to pay a penalty (regardless of whether Entity JV is able to pay the penalty);

(b) and has a right to seek reimbursement from Entity JV.

The submission asks whether, in this alternative situation, Entity A would account differently for the guarantees in each of the three fact patterns described above.

8. Appendix B to this paper reproduces the submission, which provides further details about the fact patterns and the alternative views identified by the submitter.

Findings from information request

9. We sent an information request to members of the International Forum of Accounting Standard Setters, securities regulators and large accounting firms. We also made the submission available on our website.

10. The request asked the respondents:

    (a) whether guarantees of the types described in the submission are common;

    (b) whether:

        (i) they have observed *widespread* diversity in how the issuing entities account for such guarantees;

        (ii) the issuing entities account for such guarantees differently when they are issued on the obligations of (i) joint ventures or (ii) other entities—such as associates, subsidiaries or third parties; and

    (c) if the respondents have observed *widespread* diversity:

        (i) whether the diversity has (or could have) a *material* effect on the issuing entities' separate financial statements;

        (ii) in which jurisdictions or industries the diversity is present; and

        (iii) in their view, what the root cause of the observed diversity is.

11. We received 19 responses—namely from six accounting firms, eight national standard-setters and five securities regulators[1]. The responses received represent informal opinions and do not necessarily reflect the official views of those respondents or their organisations.

[1] The five securities regulators submitted their responses through an organisation representing securities regulators, which collated the individual responses. For this paper, we have analysed the responses individually.

Are such guarantees common?

12. Twelve of the 19 respondents say guarantees of the types described in the three fact patterns are common. These respondents comprise five accounting firms, four national standard-setters and three securities regulators. Of these respondents:
    (a) two accounting firms say such guarantees are common across jurisdictions, particularly those jurisdictions which require separate financial statements prepared applying IFRS Accounting Standards.
    (b) two national standard-setters (in Asia-Oceania and Europe) say such guarantees are common in various industries. Two other national standard-setters (in Africa and Asia-Oceania) say certain types of guarantees (particularly those described in Fact Patterns 1 and 2) are common in industries with long-term contracts, such as the construction industry.
    (c) three securities regulators (in North America and Asia-Oceania) say such guarantees are common but are not commonly disclosed in the issuing entities' separate financial statements. This is because:
        (i) the amounts arising from such guarantees might not be material; or
        (ii) in some jurisdictions (including those of the securities regulators), entities are not required to prepare separate financial statements applying IFRS Accounting Standards.
    (d) some respondents—namely, three accounting firms, one national standard-setter (in Europe) and two securities regulators (in Europe)—say it is more common for entities to issue such guarantees on obligations of other entities (such as associates, subsidiaries, joint operations, related parties and third parties), rather than of joint ventures.

13. The seven other respondents did not say that such guarantees are common. Instead:
    (a) four of these respondents—namely, three national standard-setters (in Asia-Oceania and Europe) and one securities regulator (in Europe)—say they have

seen such guarantees, but did not comment on whether those guarantees are common.

(b) the other three respondents—namely, one accounting firm, one national standard-setter (in Europe) and one securities regulator (in Asia-Oceania)—say such guarantees are not common.

Is there widespread diversity?

14. Four respondents say they have observed *widespread* diversity in how entities account for guarantees of the types described in the three fact patterns:

(a) an accounting firm says diversity is observed across and within jurisdictions. This respondent says that in accounting for such guarantees, entities in some jurisdictions apply IFRS 9, while entities in some other jurisdictions apply IFRS 9, IFRS 17 *Insurance Contracts* or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. When applying IFRS 9, entities account for such guarantees as financial guarantee contracts, derivatives or loan commitments.

(b) another accounting firm says diversity is observed in Australia, Central and Eastern Europe, China (including Hong Kong), Germany, the Middle East, South Africa, South Korea and the United Kingdom. This respondent says different industries—namely, banking, insurance, construction, and shipping and manufacturing industries—take different approaches in accounting for such guarantees.

(c) a national standard-setter (in Asia-Oceania) says diversity is observed in its jurisdiction, particularly in accounting for guarantees such as those described in Fact Pattern 1. This respondent says entities account for such guarantees either:

(i) as insurance contracts applying IFRS 17; or

(ii) as financial guarantee contracts or loan commitments applying IFRS 9.

(d) another national standard-setter (in Africa) says diversity is observed in its jurisdiction. In particular:

   (i) some entities account for such guarantees only when the uncertainty has been resolved (for example, when Entity JV fails to meet its contractual obligation, thus giving rise to a contractual obligation for Entity A); and

   (ii) some other entities account for such guarantees either (i) as contingent liabilities applying IAS 37, or (ii) as insurance contracts applying IFRS 17.

15. Two national standard-setters (in Asia-Oceania and Europe) say they have observed *some* (but not *widespread*) diversity depending on the entities' types of business. For example, when accounting for such guarantees, insurers apply IFRS 17, banks apply IFRS 9 or IAS 37, while other entities apply IAS 37.

16. The remaining respondents say they have not observed *widespread* diversity. In particular:

   (a) an accounting firm says entities account for guarantees of the types described in:

      (i) Fact Patterns 1 and 3 as financial guarantee contracts applying IFRS 9 or, to a limited extent, as insurance contracts applying IFRS 17.

      (ii) Fact Pattern 2 as insurance contracts applying IFRS 17.

   (b) three respondents—namely, a national standard-setter (in Asia-Oceania) and two securities regulators (in Europe)—say entities in their jurisdictions account for such guarantees by applying IAS 37, whereas a national standard-setter (in Europe) says entities in its jurisdiction apply IFRS 9.

17. For each type of guarantee, most respondents say entities do not account for them differently based on whether the guarantees are issued on obligations of (i) joint ventures or (ii) other entities (such as associates, subsidiaries, joint operations, related parties and third parties).

Does the diversity have (or could have) a material effect?

18. Of the six respondents who have observed diversity:

    (a) four say either the diversity does not have a *material* effect or they could not confirm whether there is a material effect.

    (b) one accounting firm which has observed *widespread* diversity (see paragraph 14(b) of this paper) says the diversity has (or could have) a *material* effect in Australia, South Africa, South Korea and the United Kingdom.

    (c) one national standard-setter (in Asia-Oceania) which has observed *some* diversity (see paragraph 15 of this paper) says the diversity could *potentially* have a *material* effect.

What is the root cause of the diversity?

19. The six respondents who have observed diversity say the root cause of the diversity is a lack of clarity in the relevant requirements in IFRS Accounting Standards. In particular, the lack of clarity arises in applying:

    (a) *the scoping requirements in the relevant IFRS Accounting Standards*—namely, IFRS 9, IFRS 17 and IAS 37. As such, two of the six respondents say entities might account for guarantees with similar terms and conditions in different ways.

    (b) *the definition of 'financial guarantee contract' in IFRS 9*—three of the six respondents say entities encounter difficulty in determining whether a guarantee meets the definition of a 'financial guarantee contract' in IFRS 9, particularly because that definition contains the term 'debt instrument' which is not defined in IFRS Accounting Standards.

20. One of the six respondents—an accounting firm—says diversity also arises because of:

(a) *practical difficulty in applying IFRS 17*—this respondent says judgement is required in determining whether a guarantee is within the scope of IFRS 17, particularly when determining whether significant insurance risk has been transferred.

(b) *different terms and conditions of the guarantees*.

Staff analysis

Does the matter have a widespread effect and a material effect?

21. Paragraph 5.16 of the IFRS Foundation *Due Process Handbook* sets out the criteria the Committee considers when determining whether to add a standard-setting project to the work plan. The first criterion, included in sub-paragraph 5.16(a), is that 'the matter has widespread effect and has, or is expected to have, a material effect on those affected'.

22. The responses to the information request (as summarised in paragraphs 12–20 of this paper) indicate that there is *widespread* diversity that has (or could have) a *material* effect in several jurisdictions and industries. Although many respondents say they have not observed diversity in practice *within* their respective jurisdictions, taken together, these responses indicate that there is diversity *across* jurisdictions.

23. Therefore, in our view, the criterion set out in paragraph 5.16(a) of the *Due Process Handbook* is met.

Is it necessary to add or change requirements in IFRS Accounting Standards?

24. The second criterion, included in sub-paragraph 5.16(b) of the *Due Process Handbook*, is that 'it is necessary to add or change requirements in IFRS [Accounting] Standards to improve financial reporting—that is, the principles and requirements in the [Accounting] Standards do not provide an adequate basis for an entity to

determine the required accounting'. Paragraphs 25–42 of this paper set out our analysis of whether the matter described in the submission meets this criterion.

25. The responses to the information request indicate that:

    (a) guarantees observed in practice:

        (i) are more commonly issued on obligations of other entities, rather than on obligations of joint ventures (see paragraph 12(d) of this paper); and

        (ii) have terms and conditions that differ from one contract to another (see paragraph 20 of this paper).

    (b) in some situations, guarantees appear to be accounted for depending on the type of the entity issuing the guarantee (namely, insurers, banks or others), rather than by the terms and conditions of the guarantees in question (see paragraph 15 of this paper).

    (c) the diversity in practice is primarily driven by a perceived lack of clarity in the relevant requirements—particularly, the scoping requirements—in IFRS Accounting Standards (see paragraph 19 of this paper).

26. Assessing whether a contract is accounted for by applying the requirements in IFRS 9 for financial guarantee contracts or by applying other requirements in IFRS Accounting Standards depends on the specific facts and circumstances. Contracts or circumstances that might appear similar (or the same) might not be so when all relevant facts and circumstances are considered.

27. In analysing the question submitted, we focus our analysis on:

    (a) the scoping requirements in IFRS Accounting Standards that apply to guarantees and the order in which the scoping requirements are assessed. We have not analysed how those Accounting Standards would be applied to the specific fact patterns set out in the submission. We think our approach will be more helpful to stakeholders given the variety of fact patterns that exist in practice.

(b) guarantees that are contractual, rather than statutory or legal, based on the submission's description of the guarantees as contractual.

(c) guarantees in general, rather than only those issued on obligations of joint ventures. The question submitted asks about guarantees issued on the obligations of an entity's joint venture. However, in our view, supported by the responses summarised in paragraph 17 of this paper, the nature of the relationship between the entity issuing the guarantee and the other entity (or entities) whose obligations are subject to the guarantee does not affect the required accounting for the guarantee issued.

Analysing the terms and conditions of the guarantees

28. Guarantees can arise or be issued in many ways and convey various rights and obligations to the affected parties. IFRS Accounting Standards do not define 'guarantees'. There is also not a single Accounting Standard that applies to all guarantees issued. When determining which Accounting Standard applies to a particular guarantee that it issues, an entity is required to analyse all terms and conditions—whether explicit or implicit—of the guarantee unless those terms and conditions have no substance.[2]

29. Based on the responses to the information request and our review of IFRS Accounting Standards, we think an entity that issues a guarantee considers IFRS 9, IFRS 17 and other Accounting Standards (including IFRS 15 *Revenue from Contracts with Customers* and IAS 37) in accounting for the guarantee. We discuss the scoping requirements for each of these Accounting Standards in turn.

[2] See paragraphs 2.12 and 4.59–4.62 of the *Conceptual Framework for Financial Reporting* for the principles about the substance of the rights and obligations arising from a contract.

Is the guarantee a financial guarantee contract?

30. Based on the scoping requirements in IFRS 9, IFRS 17, IFRS 15 and IAS 37, an entity first considers whether a guarantee that it issues is a 'financial guarantee contract' as defined in Appendix A to IFRS 9:

> 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.

31. The scoping requirements in paragraph 2.1(e)(iii) of IFRS 9 and paragraph 7(e) of IFRS 17 state that financial guarantee contracts are within the scope of IFRS 9 (and IAS 32 *Financial Instruments: Presentation* and IFRS 7 *Financial Instruments: Disclosures*)—with one exception. If the issuer has previously asserted explicitly that it regards such financial guarantee contracts as insurance contracts and has used accounting that is applicable to insurance contracts, the issuer can elect to apply either IFRS 9 (and IAS 32 and IFRS 7) or IFRS 17 to the financial guarantee. Paragraph 2.1(e)(iii) of IFRS 9 states that 'the issuer may make that election contract by contract, but the election for each contract is irrevocable.'

32. The definition of a 'financial guarantee contract' in IFRS 9 specifically refers to the term 'debt instrument' (see paragraph 30 of this paper) and not to 'financial instrument' more broadly. While the term 'debt instrument' is widely used in IFRS Accounting Standards, it is not defined in any of the Accounting Standards.[3] An entity therefore applies judgement in assessing whether a guarantee issued meets the definition of a 'financial guarantee contract'.

33. At its April 2024 meeting, when discussing feedback on its post-implementation review of the impairment requirements in IFRS 9, the International Accounting Standards Board (IASB) noted that application questions about financial guarantees

[3] A few respondents to the information request attributed the diversity that they have observed to this lack of a definition (see paragraph 19(b) of this paper).

issued arise not from the impairment requirements, but rather from the general classification and measurement requirements (which include the definition of a 'financial guarantee contract'). The IASB was therefore of the view that these questions can only be resolved through broader consultation and consideration of all relevant requirements across IFRS Accounting Standards. The IASB decided to consider matters relating to financial guarantee contracts more broadly during its next agenda consultation.[4] Therefore, we recommend that the Committee not consider providing an analysis at this time of the term 'debt instrument' or when a guarantee meets the definition of a 'financial guarantee contract'.

Is the guarantee an insurance contract?

34. If an entity concludes that the guarantee it issues is not a financial guarantee contract, the entity considers whether the guarantee is an insurance contract. Appendix A to IFRS 17 defines an 'insurance contract' as [bolding omitted]:

> A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

35. Appendix A to IFRS 17 defines [bolding omitted]:

    (a) 'insurance risk' as 'risk, other than financial risk, transferred from the holder of a contract to the issuer.'

    (b) 'financial risk' as 'the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract'.

[4] See Agenda Paper 27A for the April 2024 IASB meeting and IASB *Update* April 2024.

36. IFRS 17 applies to all insurance contracts, regardless of the type of entity issuing the contracts.[5] An entity considers:

    (a) paragraphs 3–13 of IFRS 17 which set out the scoping requirements; and

    (b) paragraphs B2–B30 of Appendix B to IFRS 17 which provide further guidance on the definition of an 'insurance contract' (paragraphs B17–B23 discuss significant insurance risk). In particular:

        (i) as an example of an insurance contract, paragraph B26(f) mentions contracts, such as performance bonds, that compensate the holder if another party fails to perform a contractual obligation (for example, an obligation to construct a building); and

        (ii) as an example of a contract that is not an insurance contract, paragraph B27(d) mentions contracts that require a payment if a specified uncertain future event occurs, but do not require, as a contractual precondition for payment, the event to adversely affect the policyholder.

37. Paragraphs 8–8A of IFRS 17 state that, if a contract meets the definition of an 'insurance contract' but:

    (a) *its primary purpose is the provision of services for a fixed fee* (and all the conditions set out in paragraph 8 of IFRS 17 are met), an entity may choose to apply either IFRS 15 or IFRS 17. The entity may make that choice contract by contract, but the choice for each contract is irrevocable.

    (b) *limits the compensation for insured events to the amount otherwise required to settle the policyholder's obligation created by the contract*, an entity shall choose to apply either IFRS 9 or IFRS 17. The entity shall make that choice for each portfolio of insurance contracts, and the choice for each portfolio is irrevocable.

[5] See paragraph BC64 of the Basis for Conclusions on IFRS 17.

Other requirements in IFRS Accounting Standards that might apply

38. If an entity concludes that a guarantee it issues is neither a financial guarantee contract nor an insurance contract, the entity considers other requirements in IFRS Accounting Standards to determine how to account for the guarantee. These requirements include:

    (a) IFRS 9—the guarantee might be in the scope of IFRS 9 because it is a loan commitment[6], a derivative[7] or otherwise meets the definition of a financial liability as defined in IAS 32.

    (b) IFRS 15—if the counterparty to the guarantee is a customer, and the guarantee is not within the scope of other IFRS Accounting Standards, IFRS 15 might apply.[8] Paragraph 7 of IFRS 17 describes some types of contracts that fall within the scope of IFRS 15, such as warranties provided by the entity in connection with the sale of its goods or services to a customer.

    (c) IAS 37—only if the guarantee gives rise to a provision, contingent liability or contingent asset that is not within the scope of other IFRS Accounting Standards would IAS 37 apply.[9]

Conclusion

39. The fact patterns submitted are highly specific, and what might appear to be small or subtle differences in the specific facts and circumstances could change the conclusion when determining how to account for a guarantee issued by an entity. Making that determination requires an analysis of all terms and conditions—whether explicit or implicit—of the guarantee.

40. In our view, it would be inappropriate for the Committee to conclude on whether the guarantees described in the submitted fact patterns are accounted for as financial guarantee contracts applying IFRS 9 or by applying other requirements in IFRS

[6] See paragraph 2.3 of IFRS 9.

[7] A *derivative* is defined in Appendix A to IFRS 9.

[8] See paragraphs 5–8 of IFRS 15.

[9] See paragraph 5 of IAS 37.

Accounting Standards. We think a Committee conclusion on the submitted fact patterns:

(a) would provide little benefit for stakeholders around the world who encounter different facts and circumstances. Moreover, those stakeholders might inappropriately analogise to the conclusion.

(b) could inadvertently undermine the appropriate use of judgement that is required when applying the principles-based framework in IFRS Accounting Standards.

41. Based on our analysis in paragraphs 25–38 of this paper, we conclude that in determining which IFRS Accounting Standard to apply to a guarantee that it issues:

(a) an entity's accounting for a guarantee that it issues is based on the terms and conditions of the guarantee; it is not based on the type of entity issuing the guarantee; and

(b) an entity applies judgement in determining whether the guarantee is a financial guarantee contract in the scope of IFRS 9, an insurance contract in the scope of IFRS 17, or in the scope of other requirements in IFRS Accounting Standards (including IFRS 9, IFRS 15 and IAS 37).

42. Therefore, we conclude that the criterion included in sub-paragraph 5.16(b) of the *Due Process Handbook* (see paragraph 24 of this paper) is not satisfied—the principles and requirements in IFRS Accounting Standards provide an adequate basis for an entity to determine which IFRS Accounting Standard to apply to guarantees that it issues.

Staff recommendation

43. Based on our assessment of the work plan criteria in paragraph 5.16 of the *Due Process Handbook*, we recommend that the Committee not add a standard-setting project to the work plan. We recommend that the Committee instead publish a tentative agenda decision that identifies the IFRS Accounting Standards an entity considers in accounting for guarantees that it issues.

44. Appendix A to this paper sets out suggested wording for the tentative agenda decision. In our view, the suggested tentative agenda decision (including the explanatory material contained within it) would not add or change requirements in IFRS Accounting Standards.[10]

Questions for the Committee

Questions for the Committee
1. Does the Committee agree with our recommendation not to add a standard-setting project to the work plan? 2. Does the Committee have any comments on the wording of the tentative agenda decision suggested in Appendix A to this paper?

[10] Paragraph 8.4 of the *Due Process Handbook* states: 'Agenda decisions (including any explanatory material contained within them) cannot add or change requirements in IFRS Standards. Instead, explanatory material explains how the applicable principles and requirements in IFRS Standards apply to the transaction or fact pattern described in the agenda decision.'

Appendix A—suggested wording for the tentative agenda decision

Guarantees Issued on Obligations of Other Entities

The Committee received a request about an entity's accounting, in its separate financial statements, for guarantees that it issues.

In the three fact patterns described in the request, an entity issues several types of contractual guarantees on obligations of its joint venture. These fact patterns include situations in which the entity guarantees to make payments to a bank, a customer, or another third party in the event the entity's joint venture fails to meet the joint venture's contractual obligations under its service contracts or partnership agreements. Evidence gathered by the Committee [to date] indicated that guarantees found in practice are issued on obligations of joint ventures and other entities (such as associates, subsidiaries or third parties) and have a variety of terms and conditions.

The request asks whether the guarantees issued are financial guarantee contracts to be accounted for in accordance with IFRS 9 *Financial Instruments* or, if not, which other IFRS Accounting Standards apply to these guarantees.

Which IFRS Accounting Standards apply to guarantees?

Analysing the terms and conditions of the guarantees

Guarantees can arise or be issued in many ways and convey various rights and obligations to the affected parties. IFRS Accounting Standards do not define 'guarantees', and there is not a single Accounting Standard that applies to all guarantees. When determining which Accounting Standard applies to a particular guarantee that it issues, an entity is required to analyse all terms and conditions—whether explicit or implicit—of the guarantee unless those terms and conditions have no substance.

Is the guarantee a financial guarantee contract?

Based on the scoping requirements in IFRS 9, IFRS 17 *Insurance Contracts*, IFRS 15 *Revenue from Contracts with Customers* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, the entity first considers whether a guarantee that it issues is a 'financial

guarantee contract'. Appendix A to 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'.

Paragraph 2.1(e)(iii) of IFRS 9 and paragraph 7(e) of IFRS 17 state that financial guarantee contracts are within the scope of IFRS 9 (and IAS 32 *Financial Instruments: Presentation* and IFRS 7 *Financial Instruments: Disclosures*)—with one exception. If the issuer has previously asserted explicitly that it regards such financial guarantee contracts as insurance contracts and has used accounting that is applicable to insurance contracts, the issuer elects to apply either IFRS 9 (and IAS 32 and IFRS 7) or IFRS 17. Paragraph 2.1(e)(iii) of IFRS 9 states that 'the issuer may make that election contract by contract, but the election for each contract is irrevocable'.

Is the guarantee an insurance contract?

If an entity concludes that the guarantee it issues is not a financial guarantee contract, the entity considers whether the guarantee is an insurance contract. IFRS 17 applies to all insurance contracts, regardless of the type of entity issuing the contracts. Appendix A to IFRS 17 defines an 'insurance contract' as 'a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder'.

Appendix A to IFRS 17 defines 'insurance risk'. Paragraphs 3–13 of IFRS 17 set out the Standard's scoping requirements. Paragraphs B2–B30 of IFRS 17 provide further guidance on the definition of an 'insurance contract' and 'significant insurance risk'.

Paragraphs 8–8A of IFRS 17 state that, if a contract meets the definition of an 'insurance contract' but:

a. *its primary purpose is the provision of services for a fixed fee* (and all the conditions set out in paragraph 8 of IFRS 17 are met), an entity may choose to apply either IFRS 15 or IFRS 17. The entity may make that choice contract by contract, but the choice for each contract is irrevocable.

b. *limits the compensation for insured events to the amount otherwise required to settle the policyholder's obligation created by the contract*, an entity shall choose to apply either IFRS 9 or IFRS 17. The entity shall make that choice for each portfolio of insurance contracts, and the choice for each portfolio is irrevocable.

Other requirements in IFRS Accounting Standards that might apply

If an entity concludes that a guarantee it issues is neither a financial guarantee contract nor an insurance contract, an entity considers other requirements in IFRS Accounting Standards to determine how to account for the guarantee. These requirements include:

a. IFRS 9—the guarantee might be in the scope of IFRS 9 because it is a loan commitment (paragraph 2.3 of IFRS 9), a derivative (as defined in Appendix A to IFRS 9), or otherwise meets the definition of a financial liability as defined in IAS 32.

b. IFRS 15—if the counterparty to the guarantee is a customer, and the guarantee is not within the scope of other IFRS Accounting Standards, IFRS 15 might apply (paragraphs 5–8 of IFRS 15). Paragraph 7 of IFRS 17 describes some types of contracts that fall within the scope of IFRS 15, such as warranties provided by the entity in connection with the sale of its goods or services to a customer.

c. IAS 37—only if the guarantee gives rise to a provision, contingent liability or contingent asset that is not within the scope of other IFRS Accounting Standards would IAS 37 apply (paragraph 5 of IAS 37).

Conclusion

The Committee observed that, in determining which IFRS Accounting Standard to apply to a guarantee that it issues, an entity applies judgement considering the specific facts and circumstances and the terms and conditions of the guarantee contract. An entity's accounting for a guarantee is based on the requirements, including the scoping requirements, in IFRS Accounting Standards and is not based on the type of entity issuing the guarantee.

The Committee therefore concluded that the principles and requirements in IFRS Accounting Standards provide an adequate basis for an entity to consider when determining how to account for a guarantee that it issues.

Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

Appendix B—submission

B1. We have reproduced the submission below, and in doing so deleted details that would identify the submitter of the request.

Matter for consideration: Accounting for corporate guarantee contracts issued by the Investor entity in relation to obligations of its joint venture in its separate financial statements.

Financial Instruments

There are diverse views on whether a corporate guarantee contract issued by an investor entity in relation to obligations of its joint venture entity should be accounted for as a financial guarantee contract or not in the separate financial statements of the investor entity. We are seeking clarification from the IFRS Interpretations Committee on the issue detailed below in 3 cases.

Background

A financial guarantee contract ("FGC") is defined in Appendix A to IFRS 9 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."*

Case 1: The Investor has given corporate guarantee as a security to a Bank for its Joint Venture entity (JV) so that the Bank issues Performance Bank Guarantee (PBG) on behalf of JV entity for further submission to a third party.

In case JV entity defaults in performance and consequently, Bank is required to pay against the PBG, the Bank has the right to get reimbursement from the JV entity. If the JV entity fails to reimburse the Bank, the Bank will have a right against the investor company for the losses suffered by it.

The PBG issued by the bank is towards the performance of JV entity for timely commissioning of prescribed targets and also for meeting service obligations.

<u>**Case 2:**</u> The JV entity has entered into a service contract with a customer to deliver services at a specified future date. If the JV entity does not meet the performance obligations, the customer has a right to a fixed penalty (being compensation for default) from the JV entity. The Investor has given guarantee to the customer on behalf of its JV entity for:

(i) due and proper performance of JV's obligations, warranties, duties and undertakings as per the contract terms;

(ii) payment of the penalty amount due to the customer in connection with the (i) above in the event of default by JV entity for the performance obligations and related payment of penalty; and

(iii) also indemnify the customer against any cost, loss or liability if any guaranteed obligation becomes unenforceable, invalid or illegal and the same is not paid by the JV entity.

<u>**Case 3:**</u> Investor entity has issued guarantee in respect of the following commitments of its JV entity:

- To pay signature bonus to a third party based on achievement of development milestones in a project in which JV entity is a partner.
- To provide loan and equity contribution to the consortium on achievement of development milestone of the project undertaken by the consortium in which JV entity is a partner.

Investor is required to make payments in respect of above commitments in future when the JV entity fails to make payments in respect of these commitments when these crystalise on achievement of development milestones.

Question: Whether the above corporate guarantee contracts are Financial Guarantee Contracts to be accounted for as per IFRS 9, Financial Instruments, in the separate financial statements of the investor? If not, how should these guarantee contracts be accounted for?

Further, will it make a difference, in case the payment by the Investor to the customer is not dependent on the JV entity failing to pay, i.e., the Investor may pay the penalty to the customer on the due date and then claim it from the JV entity?

Current practices

View 1: These are not Financial Guarantee Contracts (FGC) as per IFRS 9, *Financial Instruments*

- Those in favour of this view argue that the definition of FGC uses the term 'debt instrument' and not a 'financial instrument' i.e., it does not cover all financial liabilities or financial obligations. For the purpose of recognition as a FGC, a debt instrument must be existing in the financial statements at the reporting date. It does not include potential/future debts that may arise in future and are contingent on an act. Contracts in which there is no existing debt and a future obligation may arise on happening of some event cannot be regarded as FGC at inception. It may become a financial guarantee at a later stage when the payment becomes due in the event of default by the JV entity.
- In the given cases, at the inception of the contract, there is no underlying existing debt instrument as there is no existing debtor-creditor or lender-borrower relationship between the JV entity and the guarantee holder/ beneficiary. The pre-dominant risk in these contracts is the performance risk and exposure to financial risk is dependent on the performance. In case 1 and case 2, from the perspective of investor, it is the failure to meet specified targets (i.e. non-performance) and thereafter non-payment of specified amounts by the JV entity to the beneficiary that would give rise to a contractual obligation of the investor entity (guarantor) to pay guaranteed amounts. In case 3, it is guarantee over a commitment to pay/commitment to provide loan and equity contribution on fulfilment of specified milestone. A commitment is different from a debt instrument and hence cannot be regarded as a FGC.

Some argue that such corporate guarantee contracts should be accounted for as a contingent liability as per IAS 37, while others are of the view that guarantee contracts as specified in case 1 and case 2 should be accounted for as Insurance contract as per IFRS 17

View 1A: These should be accounted for as a contingent liability as per IAS 37 (Case 1, 2 and 3).

Arguments in favour of accounting as a contingent liability as per IAS 37

- There is no present obligation as it is dependent on happening of an uncertain future event, viz. failure of performance and thereafter failure to pay penalty by JV entity. Hence, it should be accounted for as a contingent liability as per IAS 37.

View 1B: Guarantee contracts as mentioned in Case 1 and Case 2 should be accounted for as Insurance contracts as per IFRS 17

Arguments in favour of accounting as Insurance contracts (case 1 and case 2)

- IFRS 17 defines Insurance contract as a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. Insurance risk is defined as risk, other than financial risk, transferred from the holder of a contract to the issuer.
- Also, as per paragraph B26(f) of IFRS 17 performance bonds and bid bonds, i.e. contracts that compensate the holder if another party fails to perform a contractual obligation; for example, an obligation to construct a building is an insurance contract if the transfer of insurance risk is significant.
- In the given case 1 and case 2, risk that is covered appears largely to be a performance risk and not a financial risk as in substance, performance risk is 'significant' and not the financial risk. The beneficiary will be compensated if JV entity fails to perform a contractual obligation, hence it is a performance obligation which can be accounted for as an insurance contract, as per IFRS 17.

View 2: These should be accounted for as financial guarantee contracts as per IFRS 9 (for all the cases)

- Those in favour of this view argue that the term ‘debt instrument’ has not been defined and therefore, it can cover future/potential debts also ie the debt may not exist at the time the contract is entered into but may arise in case of default by the other party to perform its obligations and non-payment.

  Some argue that all financial guarantee contracts have an element of insurance as there is always an uncertain future event which will adversely affect the policy or guarantee holder. However, since in this case, there is also a financial risk involved viz. non-payment by JV, the contract is a FGC.

- In the given cases, the initial arrangement between the holder of the guarantee and the JV is akin to a debt instrument because it is the failure to pay the specified amounts by the JV that invokes the guarantee. The underlying risk from the perspective of investor entity (i.e. guarantor) is essentially a financial risk (which is though dependent on the performance of the JV), hence, the corporate guarantee meets the definition of FGC.