Accounting considerations for lenders and borrowers under the State Bank of Pakistan introduced *Refinance Scheme for Payment of Wages and Salaries to the Workers and Employees of Business Concerns*

This document has been prepared by the Institute's Technical Services team to facilitate the members and preparers of the financial statements in understanding the accounting implications of SBP introduced *Refinance Scheme for Payment of Wages and Salaries to the Workers and Employees of Business Concerns* .

The publication highlights key considerations for borrowers and lenders, in accordance with the SBP directives and International Financial Reporting Standards (IAS 9 *Financial Instruments*, IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*). Further, this publication also explains accounting of the Refinance Scheme under International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) and Revised Accounting and Financial Reporting Standard for Small-sized Entities (AFRS for SSEs).

In response to Covid-19, the State Bank of Pakistan (SBP), through IH&SMEFD Circular No. 06 of 2020 (dated April 10, 2020) has introduced a temporary *Refinance Scheme for Payment of Wages and Salaries to the Workers and Employees of Business Concerns* (the Refinance Scheme). The Refinance Scheme is managed through Participating Financial Institutions (PFIs/lenders) and funded by SBP. Businesses (borrowers) can obtain loans from the PFIs and ease their cash flow constraints and thereby avoid layoffs.

SBP under the Refinance Scheme has introduced specific features including specified refinance/service charges for PFIs and mark-up for borrowers, pre-defined repayment terms for all borrowers, discretion of PFIs in credit disbursement in accordance with the Refinance Scheme parameters and PFI's credit policies, and SBP risk sharing with PFI for a certain category of borrowers. *Please note that SBP, subsequent to above referred circular, has issued various circulars and circular letters relating to the Refinance Scheme. These can be accessed at* http://www.sbp.org.pk/smefd/circulars/2020/index.htm

Key accounting considerations

- Borrowers need to assess whether the loans obtained from PFIs under the Refinance Scheme contain any element of government grant in accordance with IAS 20. Similarly, PFIs also need to assess whether funding obtained from SBP under the Refinance Scheme contains any element of government grant in accordance with IAS 20.
- In case, element of grant exists, borrowers and PFIs are required to consider its accounting implications on the measurement of loan liability and deferred grant under the IFRS framework. The recognition of deferred grant in the profit or loss on a systematic basis also requires consideration.
- Borrowers while preparing their financial statements in accordance with IFRS for SMEs or Revised AFRS for SSEs need to consider the grant accounting related requirements of IFRS for SMEs and AFRS for SSEs as these requirements differ from IAS 20.

IFRS guidance on government grants

IAS 20 applies to the accounting for, and the disclosure of, government grants and to the disclosure of other forms of government assistance. IAS 20 (paragraph 3) defines 'government grants' as assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. Government assistance is explained in IAS 20 as an action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

IAS 20 (paragraph 10A) explains that the benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with IFRS 9 *Financial Instruments.* The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with IFRS 9 and the proceeds received. The benefit is generally accounted for and presented as deferred grant in accordance with IAS 20.

The recognition of government grants in profit or loss should be on a systematic basis over the periods in which the expenses for which the grants are intended to compensate. Under IAS 20 (paragraph 29) grants related to income should be presented either as a credit in the statement of profit or loss, either separately or under a general heading such as 'other income', or as a deduction in reporting the related expense.

Whether the Refinance Scheme contains any element of government grant or not?

SBP introduced Refinance Scheme is a temporary relief to dampen the effects of COVID-19. In substance, it is an assistance by government for businesses by providing financing at concessional terms for meeting their employees related wages and salaries. One of the key feature of the Refinance Scheme is that borrowers can obtain loan at mark-up rates that are below normal lending rates. While, SBP is providing refinance to PFIs at the service charge of 1% and 2%, as the case maybe, per anum.

The determination of whether mark-up/service charge rate is below-market (i.e. off-market) is judgmental and depends on specific facts, circumstances and terms of the arrangement. For a borrower, the off-market mark-up rate would be based on the comparison to a loan having similar characteristics (i.e. similar amount, purpose, currency, maturity, type of interest and collateral etc.).

Based on this comparison coupled with the government's underlying objective of introducing the temporary Refinance Scheme in COVID-19 situation, a transfer of resources from the government to a borrower is taking place. This transfer of resources is reflected by below-market mark-up rate on the loans obtained under the Refinance Scheme, since the borrower does not need to pay mark-up at market rate and SBP by funding at service charge rates of 1%-2% per annum is foregoing interest income at prevailing market rate.

Export Refinance Scheme

In certain other schemes, such as Export Refinance Scheme, funding facilities to businesses are made available with an aim to support industrial growth and exports (the ultimate objective of promoting overall economic development of the country). The Export Refinance Scheme reflects a government programme which sets a market for a specific type of financing facility, in substance reflecting a commercial arrangement between the market participants (rather than an assistance or relief). The Export Refinance Scheme establishes a market rate for providing funds to the exporters meeting specified criteria, and there is no incremental resource provided specifically to one exporter, as compared to other exporter. Therefore, being a particular type of financing facility available to all businesses for export purposes, the interest rate is not below-market rate.

Who are beneficiaries under the Refinance Scheme?

The SBP introduced Refinance Scheme aims to support borrowers by providing below-market loans (explained above) for payment of their employees salaries and wages, and with SBP pre-defined repayment terms.

On the other hand, under the Refinance Scheme PFIs are also being provided the incentive for lending to the borrowers. PFIs are being provided below-market refinancing by SBP. Further, in general, PFIs have discretion in the borrower selection, sanctioning of loan amount and setting the mark-up with in the specified maximum rate (based on their own credit criteria and policies). However, PFIs for lending to collateral deficient SMEs and small corporates have been provided risk coverage by SBP (SBP is sharing 40% and 60% of the loss arising from the specified category of borrowers). Besides above, for all other borrowers, PFI is exposed to the entire credit risk.

Owing to the above salient features of the Refinance Scheme, identification of beneficiaries would require special consideration.

Identification of beneficiaries: Where Refinance Scheme offers below-market rate to PFI and borrower. SBP also provides risk sharing facility to the PFI (thereby PFI credit risk is shared by SBP)

PFI

PFI is not be a beneficiary.

The PFI acts as an intermediary for the provision of loans to specified category of borrowers. PFI avails refinance from SBP at below-market service rate. However, PFI has limited discretion in utilization of these funds, as SBP requires disbursement of loans to a specified category of borrowers, against less than 100% collateral and at specified mark-up and repayment terms. SBP has provided substantial risk coverage to the PFI. in this way SBP, in substance is providing assistance to SMEs and small corporates by encouraging the PFI to disburse more loans to this category of borrowers.

Borrower

Borrower is the beneficiary.

The objective of the SBP intervention (through the Refinance Scheme and risk sharing) is to facilitate the borrowers. The specified category of the borrower obtains loan at below-market rate and with less than equivalent collateral (to the loaned facility). Further, the loan repayment is also as per SBP specified repayment terms. The borrower, therefore, obtains the economic benefits of the Refinance Scheme, including below market interest rate.

Identification of beneficiaries: Where Refinance Scheme offers below-market rate to PFI and borrowers. PFI has all the credit risk

PFI
PFI is a beneficiary.

PFI receives funds from SBP at below market rate. While considering loan applications of the borrowers, PFI has significant discretion in applying its credit policies. Therefore, PFI has discretion in making business decisions about selection of the borrower, extent of collateral and sanctioning of loan amount. Importantly, PFI carries the entire credit risk, as SBP has not provided any risk sharing facility under this part of the Refinance Scheme.

The substantial discretion in borrower selection, sanction of loan amount and exposure to credit risk indicate that PFI is not just an intermediary, rather a principal party having control of the financing obtained under the Refinance Scheme.

Borrower
Borrower is also the beneficiary.

The Refinance Scheme is designed to provide economic benefit to the borrowers, as they can obtain loans at below-market mark-up rate and as per SBP specified repayment terms. Though, borrower has to meet the eligibility criteria and credit risk requirements of a PFI. However, by availing the loan from PFI under the Refinance Scheme, the borrower obtains economic benefits (below-market mark-up). In consideration of the above and overall objective of SBP introduced Refinance Scheme, the borrower also appears to be a beneficiary.

How financing and grant should be recognised by the borrowers and PFIs?

Company as a borrower

Recognition and measurement of financial liability under IFRS 9

In accordance with IFRS 9 (paragraph B5.1.1) loan obtained under the Refinance Scheme from a PFI shall be recognised at its fair value. The fair value of the loan would be the present value of loan proceeds received, discounted using prevailing market rates of interest for a similar instrument.

The differential between the loan proceeds and fair value of the loan shall be recorded as deferred grant in accordance with IAS 20 (paragraph 10A).

In subsequent periods, the loan amount would be accreted using the effective interest method. The accreditation would increase the carrying value of the loan with a corresponding effect on the interest expense for the year in the statement of profit or loss.

As per IFRS 9 (paragraph 3.3.1), the loan liability and related mark-up shall be derecognized when it is extinguished i.e., these amounts are paid-off.

Recognition and measurement of government grant under IAS 20

The benefit of below-market interest shall be accounted for as government grant under IAS 20. In accordance with IAS 20 (paragraph 10A), the benefit, measured as the difference between the initial carrying value of the loan (i.e. fair value of the loan in this case) and the proceeds received, is government grant. This amount of grant shall be recognized and presented in the statement of financial position as ‘deferred grant’.

In subsequent periods, the grant shall be recognised in statement of profit or loss, in line with the recognition of interest expenses the grant is compensating. This amount can be presented as ‘other income’ or as reduction of related interest expense.

PFI as a borrower and lender

Recognition and measurement of receivable/payable to SBP under the Refinance Scheme

Lender shall recognize the amount(s) receivable/payable to SBP under the Refinance Scheme in accordance with SBP provisions and directives (not in accordance with IFRS 9 as this standard is applicable on Banks and DFIs from January 2021). With the settlement of these amounts, PFI’s obligation to SBP would be derecognized.

Recognition and measurement of loan receivable from borrower

PFI as lender has a legal right to receive cash payments from the borrowers (principal and mark-up), in accordance with the terms of the Refinance Scheme. PFI shall recognize the loan receivable in accordance with SBP provisions and directives. The loan receivable would be derecognized when the borrower has repaid the obligation.

Whether grant accounting would differ for companies that are preparing their financial statements under IFRS for SMEs or AFRS for SSEs?

In the IFRS for SMEs, Section 24 *Government Grants* sets out the requirements for recognition, measurement and presentation of government grants. While, in case of AFRS for SSEs, Section 12 *Government Grants* outlines grant related guidance.

The recognition of financial instruments at fair value is provided in the IFRS for SMEs as well as AFRS for SSEs. Further, IFRS for SMEs (paragraph 24.5) requires measurement of grants at the fair value of the asset received or receivable. Consequent to above similarities in the IFRS, IFRS for SMEs and AFRS for SSEs the determination of any grant element in a below-market government loan would be similar to the IFRS (i.e. The loan is measured at fair value and differential between the loan proceeds and fair value of the loan is recorded as deferred grant)

However, IFRS for SMEs and AFRS for SSEs differ from IFRS in relation to the criteria for recognition of grant income in the statement of profit or loss.

IFRS for SMEs (paragraph 24.4) and AFRS for SSEs (paragraph 12.1) provide the recognition and measurement requirements of government grant. Below is a brief discussion of these requirements and their implications on the grants accounting for the borrowers of the Refinance Scheme:

Requirements of IFRS for SMEs and AFRS for SSEs	Accounting of Refinance Scheme by borrowers under IFRS for SMEs and AFRS for SSEs
Recognition of deferred grant and credit of grant in the statement of profit or loss ▪ Under IFRS for SMEs (Section 24, paragraph 24.4 (b) and AFRS for SSEs (Section 12, paragraph 12.1(b)&(c) a government grant is not recognised until the performance conditions are actually satisfied/met. ▪ Further, IFRS for SMEs (Section 24, paragraph 24.4 (b) and AFRS for SSEs (Section 12, paragraph 12.1(b) do not allow matching of the grant with the expenses for which it is intended to compensate or the cost of the asset that it is used to finance. Rather, grant is recognised in income in the period the performance conditions are met. Further, IFRS for SMEs and AFRS for SSEs do not contain guidance about the presentation of grant in the statement of profit or loss. *(IAS 20 requires that government grants should not be recognised until there is 'reasonable assurance' that the entity will comply with the conditions attaching to them and the grants will be received. IAS 20 also requires government grants to be recognised as income over the periods necessary to match them with the related costs for which they are intended to compensate, on a systematic basis. Further, this amount can be presented as other income or as a deduction in reporting the related expense.)*	Borrowers of the Refinance Scheme should recognise the grant in income when the performance conditions are fully met. Till the satisfaction of performance obligations of the Refinance Scheme (i.e. grants received before the revenue recognition criteria are satisfied) are recognized as a liability in the financial position as 'deferred grant'. Consequently, there will be a 'point in time' recognition of grant in profit or loss in an accounting period, and not over the period recognition as outlined in IAS 20. *A performance condition is a requirement that entitles a government to the return of the granted resource if a specified event either occurs or does not occur. Any such requirement should have commercial substance to be regarded as a performance condition.*