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Accounting alert

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AASB 139 scope amendment to include financial guarantee contracts

Financial guarantee contracts issued are included within the scope of AASB 139.

In September 2005 the Australian Accounting Standards Board released AASB 2005-09 'Amendments to Australian Accounting Standards' which amends AASB 4 'Insurance Contracts', AASB 1023 'General Insurance Contracts', AASB 132 'Financial Instruments: Disclosure and Presentation' and AASB 139 'Financial Instruments: Recognition and Measurement'. In terms of the amendment, financial guarantee contracts issued are included within the scope of AASB 139. However, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either the requirements of this amendment or AASB 4.

This accounting alert provides an overview of the amendment.

Financial guarantee contracts

The accounting treatment does not depend on the legal form of the guarantee.

A financial guarantee contract is 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. Financial guarantee contracts may have various legal forms, such as guarantees, some types of letter of credit, a credit default contract or an insurance contract. The accounting treatment does not depend on the legal form the guarantee.

Financial guarantees issued are included within the scope of AASB 139 even though they may satisfy the definition of an insurance contract in AASB 4.

However, to provide a temporary solution to the concerns of issuers, if an issuer of financial guarantees has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either the requirements of the amendment or AASB 4. The issuer may make that election contract by contract, but the election for each contract is irrevocable.

Financial guarantees are initially recognised and measured at fair value.

Initial recognition of financial guarantees

Financial guarantees issued that are within the scope of AASB 139 as amended, are initially recognised and measured at fair value.

If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary.

Subsequent measurement usually at the higher of the AASB 137 amount and amount amortised under AASB 118.

Subsequent recognition of financial guarantees

Subsequent to initial recognition, financial guarantees issued are measured at the higher of:

- the amount determined in accordance with AASB 137 'Provisions, Contingent Liabilities and Contingent Assets' (i.e. the best estimate of the expenditure required to settle the obligation)
- the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with AASB 118 'Revenue'.

This treatment applies unless:

- the entity designates the liability at fair value through profit or loss in accordance with the fair value option, in which case the liability is measured at fair value with gains and losses arising on re-measurement recognised in profit or loss
- the liability arises due to the transfer of a financial asset that does not result in derecognition or is accounted for using the continuing involvement approach.

A financial guarantee issued by a parent over its subsidiary's loan is a financial guarantee within the scope of AASB 139.

Application issues

The amendment will impact the individual financial reports of entities in a group where an entity within a group provides a guarantee over loans of other entities within the group for no or non-market related compensation. For example, a financial guarantee issued by a parent entity over its subsidiary's loan is a financial guarantee within the scope of AASB 139.

Other potential issues in applying the amendment include:

- it is not clear whether letters of support and cross guarantees meet the definition of a financial guarantee contract
- the amendment does not address the accounting treatment in the accounting records of the holder of the guarantee
- amortisation recognised in accordance with AASB 118 is not explained
- inadequate guidance is provided for accounting for credit insurance contracts with cancellation, renewal and profit sharing features.

Application date

The amendments to AASB 139 and AASB 4 are effective for annual periods beginning on or after 1 January 2006, with earlier application encouraged.

Feedback and assistance

We welcome your feedback on the matters covered in this Accounting Alert – please email your comments to accounting_alerts@deloitte.com.au.

For assistance in applying the requirements outlined in your organisation, please contact your local Deloitte office or contact our Lead National Technical Partner, Bruce Porter on +61 (0) 3 9208 7490, or by email to bruporter@deloitte.com.au.