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Amendment to IAS 39 and IFRS 4 – Financial guarantee contracts

On 18 August 2005, the International Accounting Standards Board (IASB) amended the scope of IAS 39 **Financial Instruments: Recognition and Measurement** to include financial guarantee contracts issued by the entity. If an issuer of financial guarantee contracts 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 IAS 39 or IFRS 4 **Insurance Contracts** to such financial guarantee contracts.

Scope – financial guarantee contracts

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 a guarantee, some types of letter of credit, a credit default contract or an insurance contract. The accounting does not depend on the legal form of the guarantee.

Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is a credit derivative that requires payments in response to changes in a specified credit rating or credit index. These are derivatives and are not affected by the amendments. They must be measured at fair value under IAS 39.

The amendments address the treatment of financial guarantee contracts by the issuer. They do not address their treatment by the holder. Accounting by the holder is excluded from the scope of IAS 39 and IFRS 4 (unless the contract is a reinsurance contract). Therefore, paragraphs 10 to 12 of IAS 8 **Accounting Policies, Changes in Accounting Estimates and Errors** apply. Those paragraphs specify criteria to use in developing an accounting policy if no Standard applies specifically to an item.

General accounting principle

As a result of the amendment, financial guarantees issued are included within the scope of IAS 39 even though they satisfy the definition of an insurance contract in IFRS 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 this amendment or IFRS 4. The issuer may make that election contract by contract, but the election for each contract is irrevocable.

Initial recognition of financial guarantees

Financial guarantees issued that are accounted for under IAS 39 (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 of financial guarantees

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

- the amount determined in accordance with IAS 37 **Provisions, Contingent Liabilities and Contingent Assets** (i.e. the best estimate of the expenditure required to settle the obligation); and
- the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18 **Revenue**.

This treatment applies unless either:

- the entity designates the liability as 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; or
- 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.

Application issues

The amendment will impact the individual financial statements 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 IAS 39.

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;
- amortisation recognised in accordance with IAS 18 is not explained; and
- no specific guidance is provided for accounting for credit insurance contracts with cancellation, renewal and profit sharing features.

Effective date and transition

The amendments to IAS 39 and IFRS 4 are effective for annual periods beginning on or after 1 January 2006, with earlier application encouraged. If an entity adopts the amendments for an earlier period, that fact should be disclosed.

In the absence of any specific transitional provisions for these amendments they should be applied retrospectively, unless this would be impracticable.

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