KPMG

IFRS Briefing Sheet

Publication of *Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts – Financial Guarantee Contracts*

October 2005, **Issue 36**

This Briefing Sheet discusses the International Accounting Standards Board's (IASB's) publication of *Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts – Financial Guarantee Contracts,* which were issued on 18 August 2005. These amendments provide guidance on accounting by the issuer for financial guarantee contracts.

A supplement to KPMG's publication IFRS in Brief

Background

A financial guarantee contract is a contract that requires the issuer of the contract to make specified payments to reimburse the holder of the contract for a loss that the holder incurs because a specified debtor fails to make payment when due under the terms of a debt instrument.

Financial guarantee contracts can have various legal forms including some types of letters of credit, credit default contracts and insurance contracts.

Some items that are similar to financial guarantees, as defined, are not within the scope of this amendment. For example, contracts, sometimes referred to as credit derivatives, that require payments for general deterioration in credit quality of a particular borrower are not financial guarantees. Therefore, these credit derivatives must be accounted for as financial liabilities under IAS 39.

Changes to Guarantee Accounting

The amendments address the accounting for financial guarantee contracts by the issuer; they do not provide guidance on accounting for such contracts by the holder.

Under the amendments, the issuer generally accounts for financial guarantee contracts as a financial instrument liability. However, if the issuer previously had asserted explicitly that it regarded such contracts as insurance contracts and had used the accounting applicable to insurance contracts, then it may elect irrevocably to account for such contracts either as financial instruments under IAS 39 or as insurance contract liabilities under IFRS 4. In our view, this election applies to previously existing contracts, as well as similar contracts that an entity may enter into in the future. Assertions that an entity regards contracts as insurance contracts normally would be found in business documentation, financial statements and communications with customers and regulators.

Under the amendments, financial guarantee contracts that are accounted for as financial instrument liabilities under IAS 39 initially are recognised at fair value. Subsequently such contracts are measured at the higher of:

- the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets;* and
- the amount initially recognised, less, when appropriate, cumulative amortisation recognised under IAS 18 *Revenue*.

However, financial guarantee contracts that were entered into or retained on transferring financial assets or financial liabilities to another party are accounted for:

- under the requirements in IAS 39 for transfers that do not qualify for derecognition, if the contract prevents the derecognition of, or results in continuing involvement in, transferred assets; or
- as derivatives, in all other cases.

The amendments do not introduce into IAS 39 exemptions for guarantees granted by parents, subsidiaries or other entities under common control similar to those in FASB Interpretation 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Direct Guarantees of Indebtedness of Others* (FIN 45).

For example, if the contract between related parties was not written at market rates, then accounting for the financial guarantee would require initial recognition at fair value. An entity would have to determine whether any difference is a loss (gain) or capital contribution / distribution (receipt).

Effective Date

The amendments are effective for annual periods beginning on or after 1 January 2006 with earlier application encouraged.

If you would like further information on any of the matters discussed in this issue of *IFRS Briefing Sheet*, please talk to your usual local KPMG contact or call any of KPMG firms' offices.

Publication name: *IFRS Briefing Sheet*

Publication number: Issue 36

Publication date: October 2005