



**CL 50**

**PROPOSED AMENDMENTS TO IAS 39 AND IFRS 4  
FINANCIAL GUARANTEE CONTRACTS AND CREDIT INSURANCE**

*Memorandum of comment submitted in September 2004 to the International Accounting Standards Board in respect of the Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts - Financial Guarantee Contracts and Credit Insurance, published in July 2004.*

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## INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to respond to the Exposure Draft of *Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts - Financial Guarantee Contracts and Credit Insurance*, published by the International Accounting Standards Board in July 2004.
2. We have reviewed the Exposure Draft and set out below a number of comments. We deal first with major matters, and then respond to the specific questions raised in the Exposure Draft.

## MAJOR MATTERS

### Overall response

3. While we have been unable to identify a difference between financial guarantees and credit insurance of sufficient substance to support differing accounting treatments, we do not believe that the fine lines between the two types of contract imply that the relevant accounting standards are fundamentally flawed. Therefore, on pragmatic grounds, we suggest that, where insurance risk is significant, financial guarantees and credit insurance contracts should be accounted for under IFRS 4 *Insurance contracts* and no change is necessary at this stage. This will enable existing practice to continue, pending completion of Phase II of the insurance project which can deal with the issues comprehensively and set the boundary between financial guarantees and credit insurance.
4. We note that IFRS 4 contains adequate protection against the recognition of profits on inception, allows issuers of financial guarantees to follow IAS 39 *Financial instruments: recognition and measurement* and, through the requirement of a Liability Adequacy Test, indirectly requires an assessment of provisions for financial guarantees and credit insurance contracts based on the requirements of IAS 37 *Provisions, contingent liabilities and contingent assets*. There is thus sufficient protection against abuse.
5. We further note that financial guarantees are similar in nature to derivatives, which fall to be treated under IAS 39. IFRS 4 allows for a consistent treatment to be followed between financial guarantees and derivatives while also allowing for credit insurance contracts to be treated consistently with other insurance contracts.
6. It would be helpful if the Board were to include in the Application Guidance to IFRS 4 a statement that entities may use the accounting treatments that would have been available under IAS 39. This may be of particular use to entities that wish to avoid creating US GAAP differences since the IAS 39 treatment, we believe, would be consistent with FIN 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Guarantees and Indebtedness of Others*.

## **Intra-group guarantees**

7. The Exposure Draft should be mandated to not apply to guarantees issued between parents and their subsidiaries, between corporations under common control, or by a parent or subsidiary on behalf of a subsidiary or the parent where such guarantees result in the transfer of insurance risk. From the standpoint of the separate financial statements of the issuing entity, it would be difficult to value the guarantee of a related party's debt to a third party as it would not be an arm's length transaction (as any consideration that does pass in relation to the guarantee may not reflect the fair value of the guarantee). Equally, however, we do not believe that such guarantees should fall within the scope of IFRS 4. We believe this would be inappropriate for guarantees issued other than on an arm's-length basis.
8. We suggest that the Board should specifically exclude such guarantees from the scope of the Exposure Draft and IFRS 4 and make it clear that the recognition, measurement and disclosure of such guarantees should be in accordance with IAS 37.
9. The exclusion of intragroup guarantees is also consistent with the approach adopted by the FASB in FIN 45. We encourage the Board to avoid creating additional differences between IFRS and US GAAP.

## **Guarantees involving the transfer of financial risk**

10. We understand that guarantees involving the transfer of financial risk are not included within the scope of the Exposure Draft as they are already within the scope of IAS 39. However, we suggest that it would be helpful if the Board would clarify the required basis of measurement of such financial instruments.

## **SPECIFIC QUESTIONS**

### **Question 1 - Form of contract**

*The Exposure Draft deals with contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs if a specified debtor fails to make payment when due under the original or modified terms of a debt instrument (financial guarantee contracts). These contracts can have various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract. Under the proposals in the Exposure Draft the legal form of such contracts would not affect their accounting treatment (see paragraphs BC2 and BC3).*

*Do you agree that the legal form of such contracts should not affect their accounting treatment?*

*If not, what differences in legal form justify differences in accounting treatments? Please be specific about the nature of the differences and explain clearly how they influence the selection of appropriate accounting requirements.*

11. We agree that the legal form of such contracts should not affect their accounting treatment. However, as set out in paragraphs 3 to 6 above, we are unable to find a clear boundary between financial guarantees and credit insurance; we suggest that the treatment available under IAS 39 would continue to be available under IFRS 4; and

that, where insurance risk is significant, these both types of contract should continue to fall under the scope of IFRS 4, pending further consideration under Phase II of the Insurance contracts project.

### **Question 2 - Scope**

*The Exposure Draft proposes that all financial guarantee contracts should be within the scope of IAS 39 (see paragraph 2 of IAS 39 and paragraph 4 of IFRS 4), and 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” (see paragraph 9 of IAS 39).*

*Is the proposed scope appropriate?*

*If not, what changes do you propose, and why?*

12. The issue of intra-group guarantees as set out in paragraphs 7 to 9 above and guarantees involving the transfer of financial risk as set out in paragraph 10 above.
13. We note some uncertainty as to whether the term ‘specified debtor’ in the definition of a financial guarantee contract would preclude a portfolio of specified debtors where the transactions are specified. The Board should be clear about the application of the term in single and plural instances.
14. If the proposed changes are to be taken forward, the Board should clarify that IAS 39 will not apply to holders of financial guarantees and credit insurance, who should be allowed to continue to account for these products in a similar manner to the current treatment by holders of insurance contracts.

### **Question 3 - Subsequent measurement**

*The Exposure Draft proposes that financial guarantee contracts, other than those that were entered into or retained on transferring financial assets or financial liabilities within the scope of IAS 39 to another party, should be measured subsequently at the higher of:*

- (a) *the amount recognised in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets; and*
- (b) *the amount initially recognised (ie fair value) less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 Revenue (see paragraph 47(c) of IAS 39).*

*Is this proposal appropriate? If not, what changes do you propose, and why?*

15. This proposal is appropriate, subject to our comments below regarding the fair value option. The treatment in IFRS 4 is also acceptable: the Liability Adequacy Test will, in effect, ensure that the amount recognised is not less than the provision that would be applied under IAS 37 in the absence of an alternative valuation model.

16. As set out in paragraphs 3 to 6 above, we believe that the treatments in IAS 39 would currently be available under IFRS 4. This provides the option of measuring financial guarantees at fair value, which would be helpful where, for example, financial guarantees have been used as part of an overall hedging strategy.

**Question 4 - Effective date and transition**

*The proposals would apply to periods beginning on or after 1 January 2006, with earlier application encouraged (see paragraph BC27). The proposals would be applied retrospectively.*

*Are the proposed effective date and transition appropriate? If not, what do you propose, and why?*

17. If our proposal is adopted that no changes are made at this stage to the boundary between IFRS 4 and IAS 39 and that the Board clarifies that IFRS 4 allows for the IAS 39 treatment, there will be no need for a transition date.
18. If the proposals in the Exposure Draft are to be taken forward, the transitional arrangements are appropriate, subject to the minor clarification that, if early adopted in 2005, the full exemptions available under IFRS 1 *First-time Adoption of International Financial Reporting Standards* would apply.

**Question 5 - Other comments**

*Do you have any other comments on the proposals?*

19. If the proposals in the Exposure Draft are adopted, with all financial guarantee contracts dealt with under IAS 39, the drafting will entail a complex array of 'exceptions to exceptions'. We believe this will create difficulties in understanding the standard, even for those whose native language is English, with concomitant dangers of misinterpretation and misapplication. We suspect that such construction of the rules will not facilitate their translation into other languages.
20. We note that the alternatives in subparagraphs (a) and (b) in paragraph AN5A are separated with the word 'or'; the bullets in paragraph AG4A(ii) are separated with 'and'. We suggest that 'or' is correct in both cases.