FINANCIAL INSTRUMENTS FACT SHEET # 5

FINANCIAL GUARANTEE CONTRACTS	
Definition	A financial guarantee 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 in accordance with the terms of a debt instrument. Government's obligations as a "lender of last resort", e.g. where government is obliged by legislation to guarantee the debts of entities or activities, are not financial guarantee contracts. This is because the arrangement is not contractual and there is no specific debt being guaranteed. Performance guarantees, e.g. where an entity agrees to make payments because an insufficient level of revenue is generated from an activity, are not the same as financial guarantees. Performance guarantees are accounted for in terms of the Standard of GRAP on *Provisions, Contingent Liabilities and Contingent Assets* (GRAP 19).
Scope	Financial guarantee contracts are in the scope of GRAP 104.
Recognition	Recognise financial guarantee contracts when an entity becomes party to the contractual provisions of the instrument, e.g. when the financial guarantee contract is issued.
Classification	Fair value, with specific measurement after initial recognition.
Initial measurement	Fair value, which is usually equal to the consideration received for issuing the guarantee. Where no guarantee fee is charged, or the fee charged does not represent fair value (i.e. the guarantee is issued in a non-exchange transaction), an entity measures the financial guarantee at fair value. Fair value is determined by reference to the price for a similar guarantee in an active market, or by using a valuation technique. Where no reliable measure of fair value can be determined, an entity measures the financial guarantee contract at the loss allowance.
Subsequent measurement	Financial guarantee contracts are subsequently measured at the higher of fair value less any amortisation (where applicable) and the loss allowance.
Loss allowance	The credit losses (loss allowance) represent the present value of the difference between the contractual cash flows due in terms of the contractual arrangement and the cash flows an entity expects to receive. <u>Step 1: Use lifetime or 12-month expected credit losses</u> Determine if there has been a significant change in credit risk, i.e. change in risk of default occurring, since initial recognition (individual and collective assessment). Significant change in credit risk, including those that are credit impaired on origination, use lifetime expected credit losses. No significant change in credit risk, use 12 month expected credit losses. Rebuttable presumptions (unless reasonable and supportable information to indicate otherwise): • Credit risk increased significantly when contractual payments more than 30 days past due. • Default does not occur later than when a financial asset is 90 days past due.

	<u>Step 2: Measure expected credit losses</u> The expected cash flows are based on the lifetime or 12 month expected credit losses. The contractual period is the maximum period allowed. Expected credit losses are measured so that the following is reflected: • An unbiased and probability-weighted amount is determined by evaluating a range of possible outcomes. An entity must consider the possibility that a credit loss occurs, as well as the possibility that no credit loss occurs. • Time value of money. This is the effective interest rate determined at initial recognition. Expected credit losses are determined based on reasonable and supportable information about past events, current conditions and forecasts of future economic conditions, that is available without undue cost or effort.
Derecognition	A financial guarantee contract is derecognised when the obligation is discharged, cancelled, expires or is waived. When the terms of the contract are revised, an entity considers whether the existing contract should be derecognised and a new financial liability recognised. When the terms are revised such that the discounted present value of the cash flows under the new terms are more than 10% different from the discounted present value of the remaining cash flows or the original financial liability, the existing contract is derecognised and a new financial liability recognised.
Presentation and disclosure	An entity considers the presentation and disclosure requirements in GRAP 104 and applies materiality when preparing the financial statements.