GRAP 104 Reference Group

Financial guarantee contracts

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ACCOUNTING STANDARDS BOARD

Disclaimer

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Acronyms and abbreviations

Acronyms and abbreviations	Description
ECL	Expected credit loss
FGC	Financial guarantee contracts
FV	Fair value
SFPER	Statement of financial performance

Overview of today's session

The discussion is from the issuer's point of view

- What is an FGC?
- Initial recognition and measurement
- Subsequent measurement
- Loss allowance considerations
- Disclosure requirements

What is an FGC (par. 2.1)

*It 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 in accordance with the original or modified terms of a debt instrument.*

Example 1

- A controlling entity *(issuer)* guarantees a controlled entity's bank loan. The controlling entity will reimburse the bank *(holder)* for losses incurred if the controlled entity fails to pay.

- Yes, it is an FGC because there is:
  - A contract between the controlling entity and the bank
  - Specified debt, the loan from the bank
  - A specified debtor, the controlled entity
  - And the bank is only reimbursed for losses incurred on the loan due to non-payment.

Example 2

- The controlling entity issues a letter of support. This letter serves as a guarantee for the continuous payment of operational expenses by the controlled entity.

- No, it is not an FGC
  - Because no specified debt is guaranteed, it is general.

Example 3

- The controlling entity issues a letter of support. This letter guarantees that the controlling entity will support the controlled entity in case of negative equity.

- No, it is not an FGC:
  - Because the terms are not specific
  - There are no specific payments to make
  - The guarantee can cover anything

- This is a general guarantee

Initial recognition and measurement

Initial recognition **(par. 3.1)**

- Becomes a party to the contractual provisions of the instrument.

Initial measurement **(par. 5.1)**

- FV minus transaction costs *(directly attributable to acquisition)*
- FV is normally the transaction price/fee received

Recognise FGC liability		
Debit	Bank	XX
Credit	FGC liability	(XX)

Initial recognition and measurement

Initial measurement in a non-exchange transaction (AG5.28 – AG5.32)

- Often, intergroup guarantees are issued at no fee or minimal fee
- Determine FV
  - First: Quoted price in an active market for directly equivalent FGC
    - Arm's length transaction between knowledgeable and willing parties
    - FV of FGC that is substantially the same
  - Second: Valuation techniques
    - For example, mathematical models which consider financial risk could be used

Initial recognition and measurement

- If FV could be determined
  - Initial measurement = FV. Contra entry is an expense in SFPER

Recognise FGC liability		
Debit	Expense in SFPER	XX
Credit	FGC liability	(XX)

- If no FV could be determined
  - Initial measurement = Loss allowance. Contra entry is impairment loss in SFPER

Recognise FGC liability		
Debit	Impairment loss	XX
Credit	FGC liability	(XX)

Example 4

- A controlling entity *(issuer)* guarantees a controlled entity's bank loan. The controlling entity reimburses the bank (holder) for losses incurred if the controlled entity fails to pay. The controlling entity charges no fee for the guarantee.

- Considerations to determine the FV of the FGC:
  - If an independent third party provided the guarantee, what would they charge?
  - What are the terms of the loan with and without the guarantee? Determine the present value in each scenario. The difference could be the benefit received because of the guarantee.

Example 4 continue

- With guarantee:
  - R10,000, 5-year loan, monthly repayments of R210,70 and interest is 10%.
- Without guarantee:
  - 5-year loan, monthly payments of R210,70 will charge interest of 12%
  - Present value is R9,567
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Recognise FGC liability		
Debit	Expense in SFPER	R433
Credit	FGC liability	R(433)

R10,000 less R9,567

Example 5

- A controlling entity *(issuer)* guarantees a controlled entity's bank loan. The controlling entity reimburses the bank (holder) for losses incurred if the controlled entity fails to pay. The controlling entity charges no fee for the guarantee.

- The controlling entity was unable to obtain a reliable fair value for the guarantee. As a result, the controlling entity measures the FGC at the loss allowance.

- The loan amount outstanding on the date the FGC was signed as R800,000.

Example 5

- The controlled entity is experiencing financial difficulty and after taking into account all relevant information, the controlling entity estimated a loss allowance of R680,000.

Recognise FGC liability		
Debit	Impairment loss	R680,000
Credit	FGC liability	R(680,000)

Subsequent measurement

Subsequent measurement (Par.4.7(b))

- The higher of:
  - Loss allowance determined in accordance with par. 5.17 to 5.35
  - The amount initially recognised, less the cumulative amount of revenue recognised per GRAP 9 *(if applicable)*

For exchange transactions

Example 6

- A controlling entity *(issuer)* guarantees a controlled entity's bank loan for 5 years. The issuer received a fee of R1,000.
- Recognise the amortised cost of the FGC liability in terms of GRAP 9.
  - Rendering of services
  - Stage of completion – assume a straight line over 5 years

Amortise FGC liability for year 1		
Debit	FGC liability	R200
Credit	Surplus or deficit	(R200)

R1,000 / 5 years

- Balance at the end of year 1: R800 (R1,000 less R200)

Example 6

- Measure at higher of:
  - Carrying value of R800 or
  - Loss allowance
- Assume an ECL of R500 – continue to measure at R800
- Assume an ECL of R1,200 – measure at R1,200

Amortise FGC liability for year 1		
Debit	Impairment loss	R400
Credit	FGC liability	(R400)

R1,200 less R800

Loss allowance (par. 5.17 – 5.23)

- Apply the general approach
- Assess if there has been a significant increase in credit risk since initial recognition
  - Date of initial recognition = the date the issuer becomes a party to the irrevocable commitment
- Loss allowance = lifetime ECL
  - Significant increase in credit risk
  - Credit-impaired
- Loss allowance = 12-month ECL
  - All other instances

Loss allowance (par. 5.17 – 5.23)

- Cash shortfall = what must the issuer reimburse the holder less any amounts it expects to receive back *(net amount)*
- Period over which to estimate the ECL = maximum contractual period to extend credit
- When effective interest rate cannot be determined –
  - Use current market assessment of the time value of money
  - Adjust for risk specific to the cash flows (don't double account for risk – in discount rate and cash flows)
- Loss allowance is recognised as a provision
- Recognise in surplus or deficit the impairment gain or loss to adjust the loss allowance to the amount calculated at reporting date

Disclosures

- No specific disclosure requirements
- Credit and liquidity risk disclosure requirements apply to FGC
- Explain changes in loss allowance (par.8.49 and 8.50)
- Maximum exposure to credit risk (par.8.52)
  - Maximum amount the entity could have to pay if the guarantee is called on at the reporting date
- Credit risk exposure (par.8.54)
  - By credit risk rating grades, the entity's exposure to credit risk for FGC
- Liquidity risk maturity analysis (par.8.58)
  - Maximum amount of guarantee is allocated to the earliest period it could be called

Contact details

Tel: (011) 697-0660

Fax: (011) 697-0666

Email: info@asb.co.za

Website: www.asb.co.za

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