MFRS Hot Topics

Parent entity financial guarantee contracts

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Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This publication discusses the accounting for a financial guarantee contract issued by a parent entity in relation to a third party loan to a subsidiary.

Relevant MFRS

MFRS 139 Financial Instruments: Recognition and Measurement
MFRS 4 Insurance Contracts
MFRS 137 Provisions, Contingent Liabilities and Contingent Assets
MFRS 118 Revenue

Contents

Guidance

General

Financial guarantee contracts are defined in MFRS 139.9. These contracts are within the scope of MFRS 139, in accordance with MFRS 139.2(e) and 103B. This also specifies the required accounting. However, entities are permitted to apply an alternative, 'MFRS 4 approach' in some circumstances, as discussed below.

The MFRS 139 definition of financial guarantee contracts is quite narrow. In particular, the definition applies only where the guarantee relates to a debt instrument. The definition does not therefore capture product warranties, performance bonds and non-specific 'comfort letters' of the type sometimes issued by parent entities to subsidiaries (for example).

MFRS 4 approach

If, and only if, an issuer of a financial guarantee contract has previously:

- explicitly asserted that it regards financial guarantee contracts as insurance contracts and
- applied an accounting policy applicable to insurance contracts

it is permitted to apply MFRS 4 rather than MFRS 139 (MFRS 139.2(e)) (the MFRS 4 election). The assertion (ie statement) will typically be made in the entity's previous financial statements but could also be made in other documents or communications with customers and regulators (MFRS 139.AG4A). The MFRS 4 election may be made on a contract by contract basis, but cannot be revoked for a contract after it has been made.

MFRS 4 does not set out detailed requirements on accounting for financial guarantee contracts, or for insurance contracts in general. Broadly, it allows entities to continue with their existing accounting policies subject to certain conditions such as a liability adequacy test (MFRS 4.15 - 19). MFRS 4 also sets out certain limitations and principles to be followed if an entity changes its accounting policy (MFRS 4.21 - 23).

MFRS 139 approach

Entities that do not make an MFRS 4 election should account for financial guarantee contracts as follows:

- on initial recognition, the guarantee is recorded at its fair value
- subsequently the guarantee is re-measured to the higher of (i) the amount that would be required in accordance with MFRS 137; and (ii) the initial fair value amount less amortisation, when appropriate, in accordance with MFRS 118 (MFRS 139.47(c)).

Application to parent entity guarantees

The following paragraphs discuss the application of this guidance to a common situation in which:

- a subsidiary S borrows money from a third-party lender (eg a bank)
- a parent entity P issues a financial guarantee to the lender in respect of those borrowings.

(i) Consolidated financial statements

At group level, the guarantee has no separate accounting implications. In effect, the fair value of the guarantee is part of the fair value of the third party loan to S.

(ii) P's separate financial statements

The guarantee should be recorded as a liability, at its fair value. There is unlikely to be an active market in this type of guarantee, so fair value will usually need to be estimated. If the effect of the guarantee is that S pays interest on the loan at a lower rate, one way of estimating the fair value is to determine the present value of the reduction in S's interest payments.

The debit entry should be to P's cost of investment in S.

Subsequently, assuming that payment under the guarantee is not probable, the initial fair value should be amortised to income. This should be on a straight-line basis over the period of the guarantee unless an alternative method is a better approximation of the extent to which P has discharged its obligations.

(iii) S's separate financial statements

S is not a party to the guarantee contract and does not therefore account for it directly. However, if the loan is an off-market loan when viewed from S's perspective, it should be recorded at its fair value based on the terms that would have been available without the guarantee from P. If this results in a fair value that differs from the loan amount, the difference should be recorded in equity. Subsequently, the loan is measured at amortised cost using the effective interest method.

In some cases the guarantee might not have a determinable effect on the terms of the loan. For example, the bank might require a parent guarantee as a condition for extending the loan (rather than in exchange for reducing the interest rate). In such cases, the loan to the subsidiary might well be 'at market' such that the initial fair value is equal to the loan amount.

If the loan is repayable on demand (eg a typical overdraft), it must recorded at no less than the amount repayable on demand (Paragraph 47 of MFRS 13 Fair Value Measurement).

Discussion

MFRS 4 and MFRS 139 approaches

Financial guarantee contracts meet the general definition of a financial instrument. Before the issuance of MFRS 4, such contracts were clearly within the scope of MFRS 139 (MFRS 139.BC21). However, MFRS 4 created uncertainty as to whether such contracts also meet the definition of insurance contracts and should therefore be accounted for in accordance with that standard. MFRS 4 does not specify exactly how financial guarantee contracts (or insurance contracts in general) should be accounted for.

The International Accounting Standards Board amended IAS 39 (equivalent to MFRS 139) in 2005 to address these uncertainties. Broadly, the amendment (i) clarifies that financial guarantee contracts are generally within the scope of MFRS 139; and (ii) sets out the required accounting.

However, the amendment also permits entities that regard guarantee contracts as insurance contracts (and have accounted for them as such) to apply MFRS 4 rather than MFRS 139. This will allow some entities to continue with their existing accounting practices for financial guarantee contracts. Although MFRS 4 does not specify any particular accounting method, the IASB notes that credit insurers typically record a liability on issuance of an insurance contract. This might be based either on the premium received, or on estimated expected losses (MFRS 139.BC23A).

The discussion in MFRS 139.BC21-23 indicates that the MFRS 4 election is intended primarily as a compromise to allow insurance entities to maintain existing accounting practices. However, the election is available to any entity that has asserted that it regards financial guarantee contracts as insurance contracts and has established an accounting policy applicable to insurance contracts. Entities that do not meet those conditions will apply MFRS 139.

Parent entity guarantees - initial recognition

Parent entities sometimes issue financial guarantee contracts to third party lenders in respect of borrowings of a subsidiary (parent guarantees). There is no scope exception in MFRS 139 for parent guarantees. This is a difference between IFRS and US GAAP (ASC 460-10-15-7 includes a scope exception for parent guarantees). The IASB concluded that scoping out parent guarantees could lead to the omission of material liabilities. Given this focus on the completeness of liability recognition, it is important that parent guarantees are properly assessed and that a supportable fair value is determined.

Determining fair value for parent guarantees will usually require the use of an estimation technique. There is unlikely to be an available quoted price in an active market. Various estimation techniques are possible, including:

- the price for an equivalent credit insurance policy, if available
- expected losses under the guarantee (ie the probability-weighted outcomes) or
- if applicable, the present value of the reduction in the subsidiary's interest payments.

The third approach is appropriate when it is evident that the parent guarantee has enabled the subsidiary to borrow at a lower interest rate, when compared to the market rate without the guarantee. This might be clear from bank negotiations or other borrowing transactions. This approach is relatively straightforward to apply and is likely to provide a reasonable estimate (since the inputs are based on known cash flows and market interest rates).

Parent entity guarantees - subsequent measurement

After initial recognition a guarantee is re-measured to the higher of (i) the amount that would be required in accordance with MFRS 137; and (ii) the initial fair value amount less amortisation, when appropriate, in accordance with MFRS 118 (MFRS 139.47(c)).

In the case of a single guarantee, MFRS 137 would require recognition of a liability only when it is probable (ie more likely than not) that the guarantee will result in a payment. The liability would then be based on the most likely outcome (which may be the full amount guaranteed). For a portfolio of guarantees, an expected value approach should be applied (MFRS 137.14 and 40).

When a payment under the guarantee is not probable, the guarantee is measured at its initial fair value less amortisation. We consider that amortisation is appropriate when: (i) consideration is received by the guarantor; and (ii) the guarantee is for a fixed period over which the associated risk diminishes. Amortisation on a time proportion basis over the guarantee period may be appropriate (partly by analogy with loan commitment fees - see MFRS 118.IE14(b)(ii)). An alternative pattern of amortisation should be used if it is a better approximation of the extent to which the guarantor has discharged its obligations.

The consideration received in exchange for a parent guarantee is often not in the form of cash. Rather, the parent benefits indirectly because the lender:

- makes a loan to the subsidiary that would not be made without the guarantee or
- offers improved loan terms to the subsidiary (e.g. a lower interest rate).

Subsidiary's separate financial statements

If a parent entity issues a guarantee directly to a lender, the subsidiary is not party to the guarantee contract. It does not therefore account for the guarantee directly. However, the terms of the loan need to be considered. The loan, viewed from the subsidiary's perspective, might not be at 'market' terms (eg because it has an interest rate that is lower than would be available on a non-guaranteed basis). In that situation the obligations under the loan should be recorded at fair value based on the terms that would have been available without the guarantee. Consistent with the approach suggested for the parent, this fair value amount could be estimated based on the actual payments under the loan discounted at the subsidiary's arm's length cost of borrowing.

This will result in a carrying amount that is less than the amount of the loan. The difference should be credited to equity, since in substance the parent has made a capital contribution to the subsidiary by issuing a 'free' guarantee.

In many cases banks (and other lenders) require parent guarantees as a pre-condition for making loans to subsidiaries (rather than in exchange for reducing the interest rate). This is because lenders wish to protect themselves against a controlling party acting in a way that adversely affects creditors' interests. In this situation, the parent guarantee might not have a determinable effect on the terms of the loan. In these cases, the actual terms of the loan are likely to be the best indicator of 'at-market' terms, such that the fair value is equal to the loan amount.

Example

Subsidiary S borrows CU1,000,000 from a bank on 1 Jan X0. The loan bears interest at 8% and is repayable in five equal installments of CU200,000, plus interest, from 31 Dec X0 to 31 Dec X4. S's parent entity P provides the bank with a guarantee that would require P to pay the loan instalments in the event of default by S. The bank has indicated that, without the P's guarantee, it would charge an interest rate of 10% (S's cost of borrowing).

Assume that payment under the guarantee is assessed throughout the five year term as not probable. Transaction costs are ignored in this example, and it is assumed that the fair value option does not apply. P has not asserted that it regards financial guarantees as insurance contracts.

Analysis

(i) Consolidated financial statements

From a group perspective, the guarantee is not accounted for separately. The loan to S is also a liability of the group. The guarantee does not create any additional obligation. The loan is accounted for based on its stated interest rate of 8%, which also represents a market rate of interest from a group perspective. Hence the loan amount of CU1,000,000 is also the fair value on initial recognition. Subsequently, the loan is accounted for at amortised cost using an effective interest rate of 8%.

(ii) P's separate financial statements

On initial recognition the guarantee is recorded at its fair value in P's separate financial statements. This can be estimated based on the present value of the reduction in S's interest payments. The present value is determined using S's stand-alone borrowing cost of 10%. This gives an estimated fair value of CU48,369, calculated below:

Year	Loan amount outstanding during year	Actual interest at 8%	Notional interest at 10%	Reduction in interest attributable to guarantee	Present value of reduction in interest at 10%
20X0	1,000,000	80,000	100,000	20,000	18,182
20X1	800,000	64,000	80,000	16,000	13,223
20X2	600,000	48,000	60,000	12,000	9,016
20X3	400,000	32,000	40,000	8,000	5,464
20X4	200,000	16,000	20,000	4,000	2,484
Total		**240,000**	**300,000**	**60,000**	**48,369**

Subsequently, the initial carrying amount of CU48,369 should be amortised to the income statement on a basis that reflects the extent to which P has discharged its obligations. A straight-line basis is reasonable in this example, since the guarantee is for a fixed period and P's exposure reduces as S repays the loan instalments.

The accounting entries in **P's separate financial statements** are as follows:

Initial recognition on 1 Jan X0	Debit	Credit
Investment in S	CU48,369	
Guarantee liability		CU48,369

Entries in each of years X0 to X4	Debit	Credit
Guarantee liability	CU9,674	
Income (48,369/5)		CU9,674

(iii) S's separate financial statements

S is not party to the guarantee contract. No accounting is therefore required for the guarantee itself. However, it is apparent that from S's perspective the loan bears interest at an off-market rate. The loan obligations must be recorded at fair value to S. This is estimated based on the total future payments (principal plus interest), discounted at S's cost of borrowing of 10%. Subsequently, the loan is accounted for at amortised cost using an effective interest rate of 10%.

The initial fair value using this approach is CU951,631 (equal to the loan amount less the fair value of the guarantee). The amortised cost is subsequently derived based on the effective interest rate and this initial carrying amount. The calculations are shown below:

Year	Loan repayments including actual interest (A)	Present value of payments at 10%	Amortised cost of loan: beginning of year (B)	Interest expense recorded (C=10%xB)	Amortised cost of loan: end of year (B+C-A)
20X0	280,000	254,545	951,631	95,163	766,795
20X1	264,000	218,182	766,795	76,679	579,474
20X2	248,000	186,326	579,474	57,947	389,421
20X3	232,000	158,459	389,421	38,942	196,364
20X4	216,000	134,119	196,364	119,636	0
Total	**1,240,000**	**951,631**		**288,369**	

The difference between the proceeds of the loan and its initial carrying amount (CU48,369) is in substance a capital contribution to S from P. It is therefore recorded in equity.

The accounting entries **S's separate financial statements** are as follows:

Initial recognition on 1 Jan X0	Debit	Credit
Cash (loan proceeds)	CU1,000,000	
Loan obligations		CU951,631
Equity (contribution from P)		CU48,369

Cumulative subsequent entries in years X0 to X4	Debit	Credit
Interest expense	CU288,369	
Loan obligation	CU951,631	
Cash		CU1,240,000

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