

Amendments to
FRS 39 *Financial Instruments: Recognition and Measurement*
FRS 104 *Insurance Contracts*
Financial Guarantee Contracts

This document is issued as a reference. The amendments in this document have been incorporated into FRS 39 and FRS 104.

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This document sets out amendments to FRS 39 *Financial Instruments: Recognition and Measurement* and FRS 104 *Insurance Contracts* and consequential amendments to FRS 32 *Financial Instruments: Disclosure and Presentation* and FRS 107 *Financial Instruments: Disclosures*. This document also contains amendments to the Guidance on Implementing FRS 104, and Appendix C accompanying FRS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The amendments result from proposals that were contained in an Exposure Draft of Proposed Amendments to FRS 39 and FRS 104 – *Financial Guarantee Contracts and Credit Insurance* published in July 2004.

Entities shall apply these amendments for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If entities adopt these amendments for an earlier period, they shall disclose that fact.

Amendments to FRS 39

In the Introduction to FRS 39, paragraphs IN5 and IN6 are amended and their order is reversed (new text is underlined and deleted text is struck through).

- IN56 A ~~second~~ scope exclusion has been ~~added~~ made for loan commitments that are not designated ~~classified~~ as at fair value through profit or loss, ~~and~~ cannot be settled net, ~~and do not involve a~~ loan at a below-market interest rate. A commitment to provide a loan at a below-market interest rate is initially recognised at fair value, and subsequently measured at the higher of (a) the amount that would be recognised in accordance with ~~under~~ FRS 37 *Provisions, Contingent Liabilities and Contingent Assets* and (b) the amount initially recognised less, ~~where~~ when appropriate, cumulative amortisation recognised in accordance with FRS 18 *Revenue*.
- IN65 The scope of the Standard includes financial guarantee contracts issued. However, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or FRS 104 to such financial guarantee contracts. Under this Standard, a financial guarantee contract is initially recognised at fair value and is subsequently measured at the higher of (a) the amount determined in accordance with FRS 37 and (b) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with FRS 18. Different requirements apply for the subsequent measurement of financial guarantee contracts that prevent derecognition of financial assets or result in continuing involvement. Financial guarantee contracts held are not within the scope of the Standard. The treatment of financial guarantee contracts has been reviewed. Such a contract is within the scope of this Standard if it is not an insurance contract, as defined in FRS 104 *Insurance Contracts*. Furthermore, if an entity entered into, or retained, a financial guarantee on transferring to another party financial assets or financial liabilities within the scope of the Standard, the entity applies the Standard to that contract, even if the contract meets the definition of an insurance contract. An Exposure Draft proposing amendments to the treatment of financial guarantees within the scope of FRS 104 is expected to be issued in the near future.

In the Standard, paragraph 3 is deleted and paragraphs 2(e), 2(h), 4 and 47 are amended. In paragraph 9, the definition of a financial liability at fair value through profit or loss is amended, and a new definition is added immediately after the definition of available-for-sale financial assets (new text is underlined and deleted text is struck through). Paragraph AG4 is renumbered as AG3A, and paragraph AG4A is amended and renumbered as AG4. New paragraphs AG4A and 103B are added.

Paragraph 43 is presented below for convenience, but is not amended.

The amendments to paragraphs 2(h) and 47(d) transfer measurement requirements for some loan commitments from the scope section of the Standard to the measurement section, but do not change those requirements.

2 This Standard shall be applied by all entities to all types of financial instruments except:

...

- (e) ~~rights and obligations arising under (i) an insurance contract as defined in FRS 104 *Insurance Contracts*, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph 9, or (ii) under a contract that is within the scope of FRS 104 because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of FRS 104 if the derivative is not itself a contract within the scope of FRS 104 (see paragraphs 10–13 and Appendix A paragraphs AG237–AG33). Furthermore, if an insurance contract is a financial guarantee contract entered into, or retained, on transferring to another party financial assets or financial liabilities within the scope of this Standard, the issuer shall apply this Standard to the contract (see paragraph 3 and Appendix A paragraph AG4A). Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or FRS 104 to such financial guarantee contracts (see paragraphs AG4 and AG4A). The issuer may make that election contract by contract, but the election for each contract is irrevocable.~~

...

- (h) ~~except as described in paragraph 4, loan commitments that cannot be settled net in cash or another financial instrument. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction). An issuer of a commitment to provide a loan at a below-market interest rate shall initially recognise it at fair value, and subsequently measure it at the higher of (i) the amount recognised under FRS 37 and (ii) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with FRS 18. loan commitments other than those loan commitments described in paragraph 4. An issuer of loan commitments shall apply FRS 37 to other loan commitments that are not within the scope of this Standard. However, all loan ~~Loan~~ commitments are subject to the derecognition provisions of this Standard (see paragraphs 15–42 and Appendix A paragraphs AG36–AG63).~~

4 The following loan commitments are within the scope of this Standard:

- (a) ~~Loan~~ loan commitments that the entity designates as financial liabilities at fair value through profit or loss ~~are within the scope of this Standard.~~ An entity that has a past practice of selling the assets resulting from its loan commitments

shortly after origination shall apply this Standard to all its loan commitments in the same class.

(b) loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction).

(c) commitments to provide a loan at a below-market interest rate. Paragraph 47(d) specifies the subsequent measurement of liabilities arising from these loan commitments.

9 ...

Definitions of four categories of financial instruments

A financial asset or financial liability at fair value through profit or loss is a financial asset or financial liability that meets either of the following conditions.

(a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:

...

(iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

...

Definition of a financial guarantee contract

A financial guarantee contract 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.

...

Initial measurement of financial assets and financial liabilities

43 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

Subsequent measurement of financial liabilities

47 After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, except for:

(a) financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured which shall be measured at cost.

- (b) **financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or is accounted for using when the continuing involvement approach applies. Paragraphs 29 and 31 apply to the measurement of such financial liabilities.**
- (c) **financial guarantee contracts as defined in paragraph 9. After initial recognition, an issuer of such a contract shall (unless paragraph 47(a) or (b) applies) measure it at the higher of:**
- (i) **the amount determined in accordance with FRS 37 *Provisions, Contingent Liabilities and Contingent Assets*; and**
 - (ii) **the amount initially recognised (see paragraph 43) less, when appropriate, cumulative amortisation recognised in accordance with FRS 18 *Revenue*.**
- (d) **commitments to provide a loan at a below-market interest rate. After initial recognition, an issuer of such a commitment shall (unless paragraph 47(a) applies) measure it at the higher of:**
- (i) **the amount determined in accordance with FRS 37; and**
 - (ii) **the amount initially recognised (see paragraph 43) less, when appropriate, cumulative amortisation recognised in accordance with FRS 18.**

Financial liabilities that are designated as hedged items are subject to measurement under the hedge accounting requirements in paragraphs 89–102.

AG4A Financial guarantee contracts may have various legal forms, such as a ~~financial~~ guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraphs 2(e) ~~and 3~~):

- (a) ~~If the contract is not~~ Although a financial guarantee contract meets the definition of an insurance contract, as defined in FRS 104 if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or FRS 104 to such financial guarantee contracts. Thus, a financial guarantee contract that requires payments if the credit rating of a debtor falls below a particular level is within the scope of this Standard. If this Standard applies, paragraph 43 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 29–37 and AG47–AG52 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:
- (i) the amount determined in accordance with FRS 37; and
 - (ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with FRS 18 (see paragraph 47(c)).

- ~~(b) If the issuer incurred or retained the financial guarantee on transferring to another party financial assets or financial liabilities within the scope of this Standard, the issuer applies this Standard.~~
- ~~(c) If the contract is an insurance contract, as defined in FRS 104, the issuer applies FRS 104 unless (b) applies.~~
- (b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts, as defined in this Standard, and are not insurance contracts, as defined in FRS 104. Such guarantees are derivatives and the issuer applies this Standard to them.
- ~~(d) If the issuer gave a financial guarantee contract was issued in connection with the sale of goods, the issuer applies FRS 18 in determining when it recognises the resulting revenue from the guarantee and from the sale of goods.~~

AG4A Assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's communications with customers and regulators, contracts, business documentation and financial statements. Furthermore, insurance contracts are often subject to accounting requirements that are distinct from the requirements for other types of transaction, such as contracts issued by banks or commercial companies. In such cases, an issuer's financial statements typically include a statement that the issuer has used those accounting requirements.

103B *Financial Guarantee Contracts (Amendments to FRS 39 and FRS 104)*, issued in January 2006, amended paragraphs 2(e) and (h), 4, 47 and AG4, added paragraph AG4A, added a new definition of financial guarantee contracts in paragraph 9, and deleted paragraph 3. An entity shall apply those amendments for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity applies these changes for an earlier period, it shall disclose that fact and apply the related amendments to FRS 32 and FRS 104 at the same time.

Amendments to FRS 104

Paragraphs 4(d), B18(g) and B19(f) are amended (new text is underlined and deleted text is struck through), paragraph 41A is inserted and a definition of a financial guarantee contract is inserted in Appendix A after the definition of fair value and before the definition of financial risk, as follows.

4 An entity shall not apply this FRS to:

...

- (d) ~~financial guarantees contracts that an entity enters into or retains on transferring to another party financial assets or financial liabilities within the scope of FRS 39, regardless of whether the financial guarantees are described as financial guarantees, letters of credit or insurance contracts (see FRS 39) unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case the issuer may elect to apply either FRS 39 and FRS 32 or this Standard to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.~~

41A *Financial Guarantee Contracts (Amendments to FRS 39 and FRS 104), issued in January 2006, amended paragraph 4(d), B18(g) and B19(f). An entity shall apply those amendments for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity applies those amendments for an earlier period, it shall disclose that fact and apply the related amendments to FRS 39 and FRS 32 at the same time.*

Appendix A Defined terms

Financial guarantee contract

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.

Appendix B

B18 The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant:

...

- (g) credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. These contracts could have various legal forms, such as that of a ~~financial guarantee, some types of letter of credit, a credit derivative default product contract or an insurance contract. However, these contracts are outside the scope of this FRS if the entity entered into them, or retained them, on transferring to another party financial assets or financial liabilities within the scope of FRS 39 (see paragraph 4(d)).~~ However, although these contracts meet the definition of an insurance contract, they also meet the definition of a financial guarantee contract in FRS

39 and are within the scope of FRS 32 and FRS 39, not this FRS (see paragraph 4(d)). Nevertheless, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either FRS 39 and FRS 32 or this Standard to such financial guarantee contracts.

B19 The following are examples of items that are not insurance contracts:

...

- (f) a ~~financial~~ credit-related guarantee ~~contract~~ (or letter of credit, credit derivative default ~~product~~ contract or credit insurance contract) that requires payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due (see FRS 39).

Amendments to other Standards

Entities shall apply the following consequential amendments to FRS 32 (and FRS 107, if they already apply FRS 107) when they apply the related amendments to FRS 39 and FRS 104.

FRS 32 *Financial Instruments: Disclosure and Presentation*

Paragraphs 4(d) and 12 are amended (new text is underlined) as follows.

4 This Standard shall be applied by all entities to all types of financial instruments except:

...

(d) insurance contracts as defined in FRS 104 *Insurance Contracts*. However, this Standard applies to derivatives that are embedded in insurance contracts if FRS 39 requires the entity to account for them separately. Moreover, an issuer shall apply this Standard to financial guarantee contracts if the issuer applies FRS 39 in recognising and measuring the contracts, but shall apply FRS 104 if the issuer elects, in accordance with paragraph 4(d) of FRS 104, to apply FRS 104 in recognising and measuring them.

12 The following terms are defined in paragraph 9 of FRS 39 and are used in this Standard with the meaning specified in FRS 39.

...

- financial asset or financial liability at fair value through profit or loss
- financial guarantee contract
- firm commitment

...

FRS 107 *Financial Instruments: Disclosures*

Paragraph 3(d) of FRS 107 and the list of defined terms in Appendix A of FRS 107 are amended in the same way as FRS 32 (new text is underlined), as follows.

3 This FRS shall be applied by all entities to all types of financial instruments, except:

...

(d) insurance contracts as defined in FRS 104 *Insurance Contracts*. However, this FRS applies to derivatives that are embedded in insurance contracts if FRS 39 requires the entity to account for them separately. Moreover, an issuer shall apply this FRS to *financial guarantee contracts* if the issuer applies FRS 39 in recognising and measuring the contracts, but shall apply FRS 104 if the issuer elects, in accordance with paragraph 4(d) of FRS 104, to apply FRS 104 in recognising and measuring them.

Appendix A

Defined terms

...

The following terms are defined in paragraph 11 of FRS 32 or paragraph 9 of FRS 39 and are used in the FRS with the meaning specified in FRS 32 and FRS 39.

...

- financial asset or financial liability at fair value through profit or loss
- financial guarantee contract
- financial asset or financial liability held for trading

...

References to be updated when an entity adopts FRS 107

When an entity applies FRS 107, references to FRS 32 are replaced by references to FRS 107 in the following paragraphs that were added or amended by this document:

- FRS 39, paragraph 103B
- FRS 104, paragraph IN3 of the introduction, paragraphs 4(d) and 41A, and paragraph B18(g) of Appendix B (two references)

Implementation Guidance

Amendments to Guidance on Implementing FRS 104

In the Guidance on Implementing FRS 104, IG Examples 1.11 and 1.12 are amended (new text is underlined and deleted text is struck through), as follows.

IG Example 1: Application of the definition of an insurance contract		
	<i>Contract type</i>	<i>Treatment in phase I</i>
1.11	<p>Contract that requires <u>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 under the original or modified terms of a debt instrument.</u> The contract may have various legal forms (e.g. insurance contract, financial guarantee or letter of credit).</p>	<p><u>Insurance contract, but within the scope of FRS 39, not FRS 104. However, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either FRS 39 and FRS 32 or FRS 104 to such financial guarantee contracts.</u> Within the scope of the FRS, unless the contract was entered into or retained on the transfer of financial assets or financial liabilities within the scope of FRS 39.</p> <p>If the issuer's accounting policies do not require it to recognise a liability at inception, the liability adequacy test in paragraphs 15-19 of the FRS may be particularly relevant.</p> <p>The legal form of the contract does not affect its recognition and measurement.</p> <p><u>Accounting by the holder of such a contract is excluded from the scope of FRS 39 and FRS 104 (unless the contract is a reinsurance contract). Therefore, paragraphs 10-12 of FRS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i> apply. Those paragraphs specify criteria to use in developing an accounting policy if no FRS applies specifically to an item.</u></p>
1.12	<p>A <u>credit-related</u> financial guarantee that does not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a <u>guarantee contract</u> is one that requires payments in response to changes in a specified credit rating or credit index.</p>	<p>Not an insurance contract. A <u>derivative within</u> Within the scope of FRS 39.</p>

Reference to be updated when an entity adopts FRS 107

When an entity applies FRS 107 *Financial Instruments: Disclosures*, the reference to FRS 32 in IG Example 1.11 is replaced by a reference to FRS 107.

Amendments to Appendix C accompanying FRS 37

In Appendix C, example 9, the second paragraph is amended so that it refers to accounting in accordance with FRS 39 and FRS 104 (new text is underlined), as follows (deleted text is struck through).

The note at the end of example 9 ('Where an entity guarantees...FRS 18 *Revenue*.') is deleted.

...

This contract meets the definition of an insurance contract in FRS 104 *Insurance Contracts*, but is within the scope of FRS 39 *Financial Instruments: Recognition and Measurement*, because it also meets the definition of a financial guarantee contract in FRS 39. If an issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either FRS 39 or FRS 104 to such financial guarantee contracts. FRS 104 permits the issuer to continue its existing accounting policies for insurance contracts if specified minimum requirements are satisfied. FRS 104 also permits changes in accounting policies that meet specified criteria. The following is an example of an accounting policy that FRS 104 permits and that also complies with the requirements in FRS 39 for financial guarantee contracts within the scope of FRS 39.

...