



Issued financial guarantee contracts

Accounting under
IFRS 17 and IFRS 9

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Issued financial guarantee contracts



What's the issue?

Under a financial guarantee contract, the issuer is required to reimburse a loss incurred by the holder. A common example of a financial guarantee contract is a parent company providing a guarantee over its subsidiary's borrowings.

Because these contracts transfer significant insurance risk, they typically meet the definition of an insurance contract.

With the replacement of IFRS 4 *Insurance Contracts* by IFRS 17 *Insurance Contracts*, the accounting for these contracts may change significantly. Companies now need to apply either IFRS 17 or IFRS 9 *Financial Instruments* to these contracts.



What's the impact?

The impact on the financial statements will differ depending on whether a company applies IFRS 17 or IFRS 9.

The key impacts include:

- the measurement of the contract liability; and
- the timing of profit recognition.



What's next?

Companies need to assess now whether to apply IFRS 17 or IFRS 9 to financial guarantee contracts they have issued.

To help with this assessment, we share our insight and practical guidance, including a worked example of accounting for a financial guarantee contract under both IFRS 17 and IFRS 9.

Issued financial guarantee contracts

How might your accounting change?

01

Financial guarantee contracts explained

02

Determining whether to apply IFRS 17

03

Applying IFRS 17

04

Applying IFRS 9

05

Intra-group financial guarantee contracts

06

Worked example

07

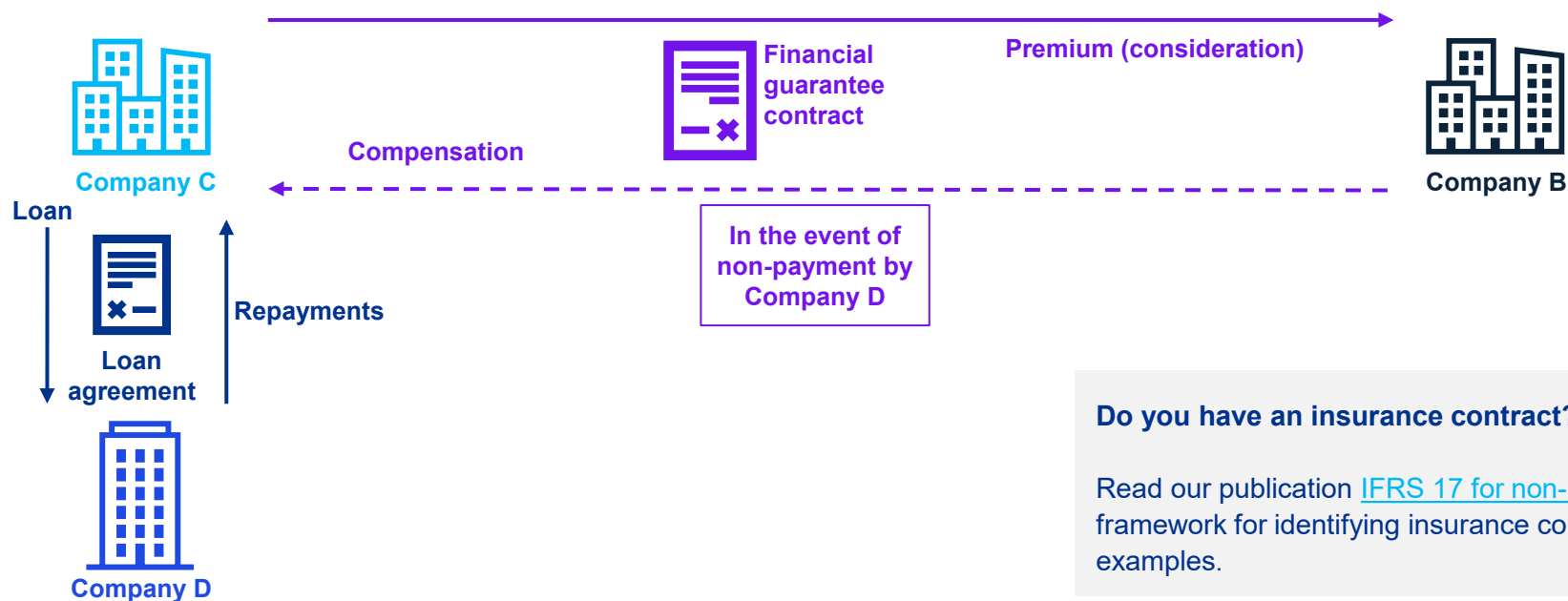
Next steps

01 Financial guarantee contracts explained

Financial guarantee contracts typically meet the definition of an insurance contract under IFRS 17.

A financial guarantee contract is an agreement that requires the issuer to compensate the holder for losses it incurs because a specified debtor fails to make specified payments when due under the terms of a debt instrument.

Consider an example where Company C has provided a loan to Company D. C purchases a guarantee from Company B in exchange for a premium. Under the guarantee, B (issuer of the financial guarantee contract) will compensate C if D fails to make the payments required under the loan to C.



Do you have an insurance contract?

Read our publication [IFRS 17 for non-insurers](#), which includes a framework for identifying insurance contracts and illustrative examples.



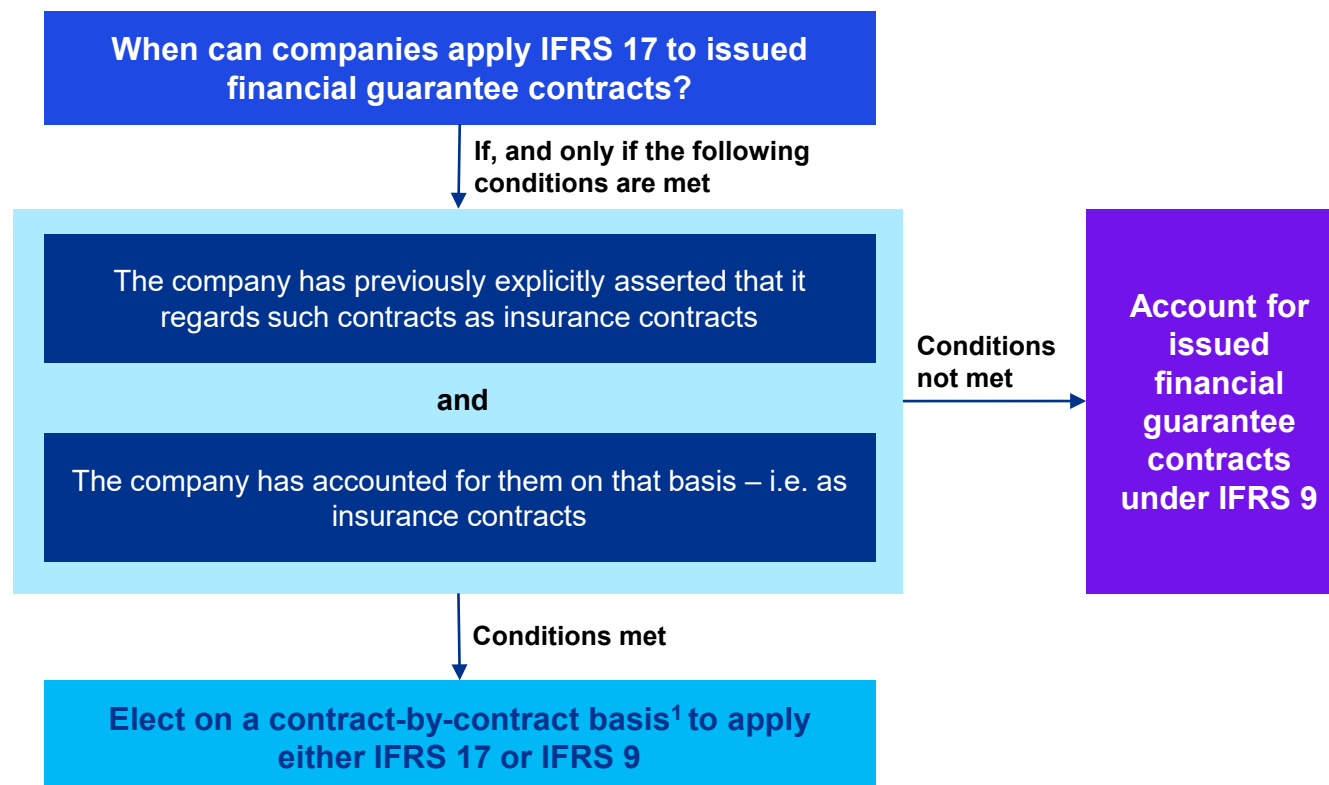
02 Determining whether to apply IFRS 17

Significant accounting change(s) may arise for companies that:

- issue financial guarantee contracts; and
- previously accounted for those contracts under IFRS 4.

Unlike IFRS 4 (which no longer applies), under IFRS 17 grandfathering of accounting policies is not available. Therefore, on transition to IFRS 17 companies may need to reassess how to account for financial guarantee contracts they issue(d).

A company can only apply IFRS 17 if certain conditions are met. However, even if it meets the conditions, it can irrevocably elect on a contract-by-contract basis to apply either IFRS 17 or IFRS 9.



¹ The same election may be available on initial recognition of a new financial guarantee contract.

03 Applying IFRS 17

When a company issues a financial guarantee contract, it will typically receive a **premium** in exchange for its commitment to compensate the contract holder in the event that the third party defaults – i.e. the issuer has a **liability** to provide coverage to the contract holder.

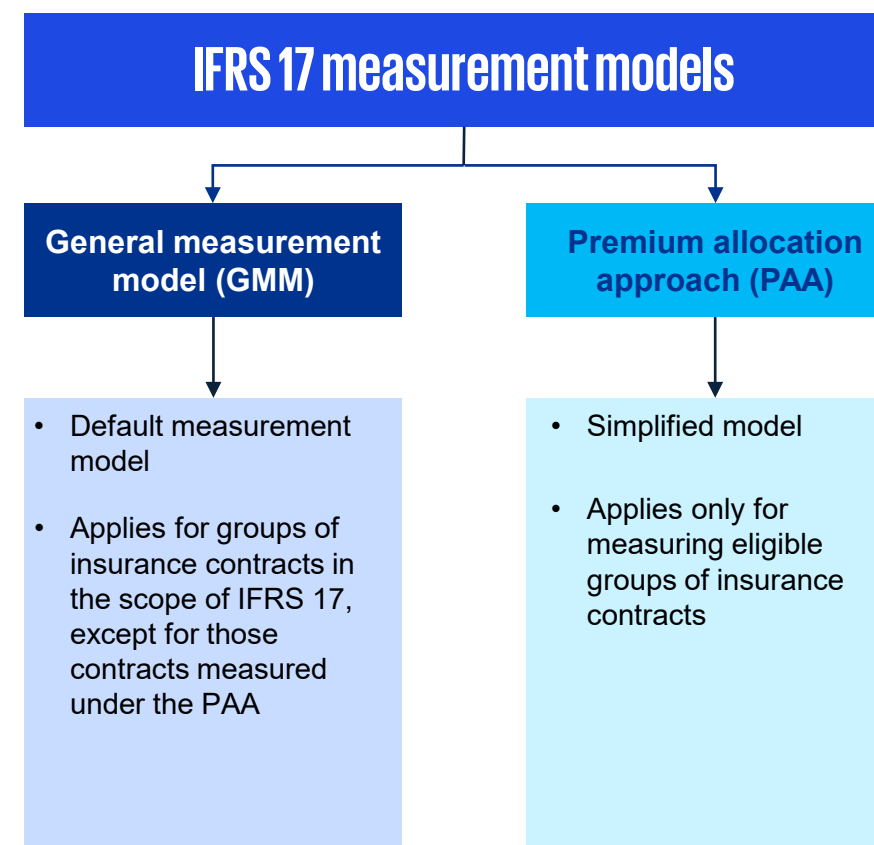
This liability comprises:

- a liability for remaining coverage (LRC) – e.g. the obligation to pay compensation for any future defaults; and
- a liability for incurred claims (LIC) – e.g. the obligation to pay compensation for any defaults that have already occurred.

A company can measure the liability under the GMM or PAA, depending on the relevant facts and circumstances for each group of contracts.



The GMM is the default measurement model under IFRS 17. Read our publication [First Impressions](#) to find out more about measurement models and eligibility under IFRS 17.



03 Applying IFRS 17 (cont.)

Measurement of the liability and amounts recognised in profit or loss under the GMM and PAA measurement models are as follows.

General measurement model

Premium allocation approach

	General measurement model	Premium allocation approach
Measurement of LRC (future defaults)	<ul style="list-style-type: none"> The liability comprises: <ul style="list-style-type: none"> the present value of probability-weighted estimates of future cash flows (these include all cash flows that relate directly to the fulfilment of the contract, including premiums, expected defaults and administration expenses); a risk adjustment representing the compensation required for bearing 'non-financial risk' (which includes uncertainty about amounts payable under the guarantee); and the contractual service margin (CSM) representing deferred profit. 	<ul style="list-style-type: none"> Based on unearned premium received, unless the group of contracts is onerous – in which case the LRC is measured as under the GMM (subject to possible simplifications regarding financial risk). For groups of contracts that become onerous (e.g. because of a deterioration in the counterparty's credit risk), the expected loss is recognised immediately and the liability is increased.
Measurement of LIC (defaults incurred)	<ul style="list-style-type: none"> Based on actual defaults incurred. Does not include any CSM. 	<ul style="list-style-type: none"> Based on actual defaults incurred. Discounting is not required if defaults are expected to be settled within one year of being incurred.
Amounts recognised in the statement of comprehensive income	<ul style="list-style-type: none"> Generally reflects the allocation of revenue based on expected claims and expenses and release of the risk adjustment for non-financial risk, the CSM (plus any experience adjustments to premiums) and actual defaults. Insurance finance expense would also be recognised for the effect of and changes in the time value of money and financial risk. 	<ul style="list-style-type: none"> Generally reflects the insurance revenue recognised, reduced by the actual defaults. Insurance finance expense would also be recognised for changes in the effect of discounting.

04 Applying IFRS 9

The financial guarantee contract is initially measured at its fair value. Generally, this is the consideration received under the contract.

At each reporting date the financial guarantee contract is subsequently measured at the higher of:

- the amount initially recognised less the cumulative amount of income recognised in accordance with the principles of IFRS 15 *Revenue from Contracts with Customers*; and
- the loss allowance – i.e. the expected credit losses (ECL) under IFRS 9.

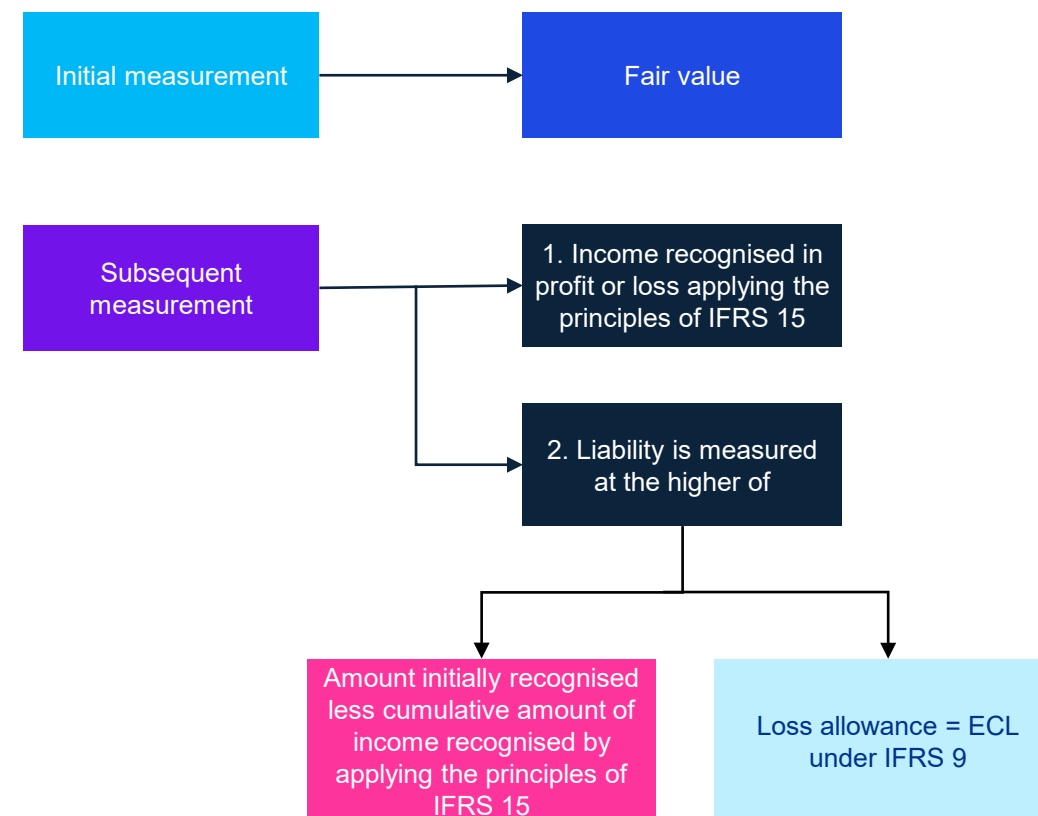
A company recognises income based on the principles of IFRS 15.

If the company remeasures the contract to the amount of the loss allowance, then it also recognises an impairment loss.



Unlike IFRS 17, when determining the loss allowance under IFRS 9, the company does not include an explicit risk adjustment for non-financial risk. However, the discount rate used to calculate ECLs would reflect the additional compensation that the issuer would demand for risks specific to the cash flows.

IFRS 9 measurement of financial guarantee contracts



05 Intra-group financial guarantee contracts

For a financial guarantee contract issued by a parent over the liability of its subsidiary to a third party, if no consideration from the subsidiary or holder to the parent is agreed, then it appears that the parent has provided the guarantee in its capacity as a shareholder. Therefore, the parent accounts for the contract in its **separate financial statements** as a capital contribution to the subsidiary. This represents the **deemed premium** for the guarantee.

Measuring the deemed premium may differ between IFRS 17 and IFRS 9, as set out in the table below.

IFRS 17

IFRS 9

Measurement of deemed premium by parent company (issuer)

- We believe the deemed premium is measured either at the **fair value** of the guarantee or at an amount equal to the guarantee's **fulfilment cash flows**¹.

- The deemed premium is measured at **fair value** on initial recognition.



In our experience, in the **group financial statements** the issued guarantee is usually included in the measurement of the guaranteed financial liability – i.e. it is not accounted for separately.

¹ 'Fulfilment cash flows' in this context refers to fulfilment cash flows other than premiums. Although no explicit premium is charged, we believe that the parent needs to include a risk adjustment for non-financial risk when measuring the fulfilment cash flows.

06 Worked example

The following example illustrates the carrying amounts of the financial guarantee contract liability and the amounts recognised in profit or loss under IFRS 17 and IFRS 9. The amounts are denominated in euros.

Fact pattern

- On 1 January 2022, Company G issues a financial guarantee contract to Company F for a premium of 300.
- Under the contract, G will reimburse F on 31 January 2025 for defaults that F incurs from a specified pool of trade receivables between 2022 and 2024.
- F expects to incur total defaults of 120 throughout the three-year coverage period – i.e. 40 in each of the three years. Assume that defaults are incurred as expected.
- G determines that it will recognise the contract consideration of 300 and the deferred profit (or CSM) in profit or loss on a straight-line basis.
- G applies the default measurement model under IFRS 17 for insurance contracts – i.e. GMM.
- The effect of discounting and the risk adjustment for non-financial risk and administration expenses is ignored.
- G expects a loss allowance of 120 at each reporting date under IFRS 9.

06 Worked example (cont.)

If G were to measure the contract under IFRS 17's general measurement model, it would record the following amounts.

Extract from balance sheet

31 December (amounts in euros)	2022	2023	2024
Carrying amount of insurance liability ¹	240	180	120
• Liability for remaining coverage ²	200	100	-
• Liability for incurred claims	40	80	120

Extract from income statement

Year ended 31 December (amounts in euros)	2022	2023	2024	Total
Profit for the year	60	60	60	180
• Insurance revenue ³	100	100	100	300
• Insurance service expenses ⁴	(40)	(40)	(40)	(120)

Notes:

1. If G were to apply the PAA model, then the liability for remaining coverage equals the consideration received for the financial guarantee contract less the amounts released to profit or loss.
2. The liability for remaining coverage under the GMM comprises G's estimate of future defaults under the contract and the deferred profit.
3. Under the GMM, insurance revenue comprises G's expected defaults for the year and the deferred profit (CSM) earned during the year. G expects to release its expected defaults and the deferred profit (CSM) on a straight-line basis. Under the simplified model (PAA), G would release the contract consideration (premium) of 300 to profit or loss on a straight-line basis.
4. G recognises defaults of 40 each year as insurance service expenses as incurred.

06 Worked example (cont.)

If G were to measure the contract under IFRS 9, it would record the following amounts.

Extract from balance sheet

31 December (amounts in euros)	2022	2023	2024
Financial guarantee contract liability	200	120	120
Representing the higher of:			
• Amount initially recognised less cumulative amount of income recognised under IFRS 15 ¹	200	100	-
• Loss allowance	120	120	120

Extract from income statement

Year ended 31 December (amounts in euros)	2022	2023	2024	Total
Profit for the year ³	100	80	-	180
• Fee income ¹	100	100	100	300
• Impairment loss ²	-	(20)	(100)	(120)

Notes:

1. G releases the amount initially recognised for the financial guarantee contract on a straight-line basis to profit or loss under IFRS 15.
2. G remeasures the financial guarantee contract at 31 December 2023 and 31 December 2024. This is because the loss allowance exceeds the amount comprising that initially recognised less the cumulative amount of income recognised under IFRS 15.
3. Based on the fact pattern in this worked example, profit recognition under IFRS 9 is accelerated relative to IFRS 17. However, there may be scenarios based on different fact patterns where IFRS 17 profit recognition may be consistent with or accelerated relative to IFRS 9.

07 Next steps



Determine whether you issue financial guarantee contracts

... including guarantees issued by a parent company to guarantee the repayment of their subsidiaries' debts, where the parent company prepares separate financial statements.



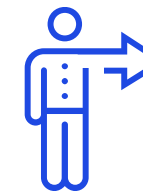
Understand your previous accounting policies

... and that the irrevocable election to measure financial guarantee contracts under IFRS 17 or IFRS 9 is only available if you previously asserted explicitly that you regard issued financial guarantee contracts as insurance contracts, and have accounted for them as such.



Consider the impact under IFRS 17 and IFRS 9

... particularly the impacts on the measurement of the liability and when amounts are recognised in profit or loss.



Decide on applying IFRS 17 or IFRS 9

... on a contract-by-contract basis, based on the eligibility criteria for each financial guarantee contract.

Keeping in touch



Joachim Kölschbach
Global IFRS Insurance Contracts
Leader
KPMG in Spain
jkolschbach_extcolab@kpmg.es



Patouche Van Staaij
Executive Director, Audit
KPMG in Belgium
pvanstaaij@kpmg.com



Bob Owel
Global IFRS Insurance Contracts
Deputy Leader
KPMG International
bob.owel@kpmgifrg.com



Colin Martin
Global IFRS Financial Instruments
Leader
KPMG International
colin.martin@kpmgifrg.com

With thanks to our additional contributors

Albert Chai Arlene Joseph Uni Choi Viresh Maharaj Gina Desai Chris Spall

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