

# Guarantors Accounting and Disclosure

Exposure Draft

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# Guarantor's Accounting –Timeline

February 13, 2002 – FASB Separated from Consolidation Project

May 22, 2002 – FASB Issued Exposure Draft

June 21, 2002 – Deadline for Comment Letters

August 7, 2002 – FASB Resumes Deliberation of Project

- This meeting was the first public discussion of the Exposure Draft since the receipt of comment letters in June. The Board is now expecting to issue a final Interpretation around October 31. The Board voted 5-2 in favor of the following tentative decisions

# The Highlights

Purpose: To clarify requirements of guarantor's accounting and disclosures for guarantees, including the residual guarantee inherent in synthetic leases.

Amount of Guarantee Recognized/Booked: At the inception of the guarantee, the lessee must recognize a liability. Originally this was to be recorded at "fair value" (that is, the market value) of all of the obligations that the guarantor has undertaken in a synthetic lease.

# Highlights - Measurement

At the August 7<sup>th</sup> meeting the fair value measurement requirement was eliminated (largely because this is viewed as an effective amendment of FAS 5).

Instead, fair value will be suggested as the objective, but other methods of valuation may be acceptable. These methods include applying other areas of accounting literature and facts and circumstances (i.e., receipt of actual cash payment for a guaranty is indicative of value – cash collateralization).

“Principles-based” examples will be developed for the Interpretation.

# Highlights - Disclosure

- Required Disclosures: To satisfy the requirements, a guarantor must disclose the:
  - (a) nature of the guarantee, including how the guarantee arose and the events or circumstances that would require the guarantor to perform under the guarantee;
  - (b) maximum potential amount of future payments under the guarantee;
  - (c) carrying amount of the liability, if any, for the guarantor's obligations under the guarantee; and
  - (d) nature and extent of any recourse provisions or available collateral that would enable the guarantor to recover the amount it pays under its guarantee.

# Guarantor's Accounting – Disclosure Requirements

What has changed?

- Current requirement - the nature and amount of guarantees only

# Recognition Requirements

- Requires a guarantor to recognize, at the inception of a guarantee, a liability for all the obligations it has undertaken in issuing the guarantee, including its ongoing obligation to stand ready to perform over the term of the guarantee in the event that the triggering event or conditions occur.
- What has changed? Many entities are not recognizing a liability for issuing a guarantee because the recognition requirements have not been met at the inception of the guarantee.

# Recognition Open Issues

- **Offsetting Initial Entry.** This issue not addressed, but principles-based examples will be presented.
  - Debit to expense or prepaid
  - Credit to "stand-ready" liability
- **Subsequent Accounting.** This issue not addressed, but guidance will be provided.
  - Should a guarantee be marked to market every year?  
Assuming the guarantee has a limited life by its express terms, risk will arguably decline over time, which suggests that amortizing the liability is appropriate.

# Recognition Open Issues

- On the other hand, perhaps the FASB expects a guarantor to continue to report the entire liability until the obligation to stand-ready expires. Only then, could the guarantee be recorded into income with a single accounting entry as follows:
  - Debit to "stand-ready" liability
    - Credit to income
- What if the guaranty is not limited in duration by its terms? In that case, will guarantor ever be permitted to take it into income? Draft is silent thus far.

# Recognition – Principles Based

The Board is holding fast to developing more principles-based accounting standards and, therefore, generally rejected requests for more specificity and addressing issues not contained within the scope of the Interpretation.

However, they agreed in many areas to provide “principles-based” guidance but not rules-based examples. The tension between rules and principles persisted throughout discussion and will likely continue through consideration of the Exposure Draft on Consolidations.

# Recognition – Principles Based

The Board recognized that the lack of specificity on measurement can affect comparability and create opportunity for manipulation. They discussed separating the disclosure and recognition components and elevating recognition to a project on a new standard that would include subsequent accounting, but this approach was defeated.

Trying to mark contingent obligations to market (or using another valuation method), when no market exists and no payment on the contingent obligations is likely, is a substantial departure from historical cost accounting. While GAAP departs from historical cost accounting in other contexts, it is generally only where established markets provide a basis for valuation.

# ED Applies To:

- Contracts that contingently require the guarantor to make payments (either in cash or in other assets, services, or financial instruments) to the guaranteed party based on changes in an underlying that is related to an asset or liability of the guaranteed party.
  - Standby Letter of Credit, which is irrevocable.
  - Market Value Guarantee on either securities or a nonfinancial asset.
  - Guarantee of Cash Flows.

# ED Applies To:

Contracts that contingently require the guarantor to make payments (either in cash or in other assets, services, or financial instruments) to the guaranteed party based on another entities failure to perform under an obligating agreement (Performance guarantees).

Indemnification agreements (contracts) that generally require the guarantor to make payments to the guaranteed party based on the occurrence of a specified event (ie adverse judgment in a lawsuit, or the imposition of additional taxes due to change in law or an adverse interpretation).

Indirect guarantees of indebtedness of others.

# ED Applies To:

The scope of the Draft is not limited to transactions styled "guaranty" or "indemnity." Contingent liabilities are created in commercial contracts in many ways.

# Effect on Existing Lease Transactions

**Existing** residual guarantees of operating leases and vendor guarantees will be largely unaffected since they will not need to be recognized and are already disclosed in most cases. The change in measurement requirements will likely create more flexibility for preparers to use appropriate and sound approaches as they see fit.

# Effective Dates....

**Effective Date.** Disclosure requirements would be effective for fiscal periods commencing after December 15, 2002. Recognition requirements would be effective as of January 1, 2003.

**Transition.** Existing guarantees and obligations would be grandfathered for purposes of recognition but would need to be disclosed. **Only new obligations undertaken after January 1, 2003 would need to be recognized.**

# Waiting On SPE Accounting May No Longer Be Prudent!

Refinancing or restructuring of existing lease arrangements after January 1, 2003 which trigger reclassification will likely be subjected to the recognition requirements. This creates a conundrum for synthetic lease users who may be waiting for the conclusion of Consolidations to restructure their leases.

# Still Unresolved....

The debit and subsequent accounting for guarantees remains an open judgment at this point and the playing field will turn to preparers and auditors. The burden will be on preparers to provide sound arguments to support their positions.