

defining issuesTM

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Accounting and Disclosure by Guarantors

Guarantors will have to meet new disclosure and liability-recognition requirements for guarantees of debt that fall within the scope of newly issued FASB Interpretation 45.¹ A liability must be recognized at the inception of a guarantee covered by the new requirements whether or not payment is probable, because the Interpretation creates the new concept of a "stand-ready" obligation. Guarantors will have to navigate the Interpretation's detailed scope provisions to determine whether or which of their guarantees are covered by the Interpretation, mindful that some guarantees will be subject only to the disclosure requirements and others to both the disclosure and recognition requirements. The implementation period will pose challenges, because the disclosure requirements are effective for interim and annual periods after December 15, 2002. Companies will have to identify guarantees in arrangements entered into prior to December 31, 2002 in order to comply with the disclosure requirements.

This edition of *Defining Issues* describes the new major requirements and identifies several potential difficulties in applying them.

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(1) FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others: an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34, November 2002.*

SCOPE

Interpretation 45 applies to guarantors only and applies only to direct and indirect guarantees with specified contract characteristics. Some guarantees and indemnification agreements are excluded from the entire Interpretation. Others are excluded solely from the initial recognition and measurement provisions.

Guarantees explicitly covered by the Interpretation can be summarized by two characteristics: Payments under the conditions of the guarantee are required

- If another entity fails to perform under an obligation agreement or
- If there are specified changes in an “underlying” that is related to a guaranteed party’s asset, liability, or equity security (for example, indemnification agreements and indirect guarantees of indebtedness).

An “underlying” is a variable, such as a specified interest rate or securities price. The Interpretation states that an “underlying” includes the occurrence or nonoccurrence of a specified event, such as a scheduled payment under a contract.²

This makes clear that the Interpretation’s provisions apply to indemnification agreements with payment triggered by a specified event, such as an adverse judgment in a lawsuit, the imposition of additional taxes caused by either a change in the tax law or an adverse interpretation of the tax law related to the sale of assets or parts of a business.

The guarantees explicitly covered by Interpretation 45 include indirect guarantees of indebtedness as treated in Interpretation 34.³ The prior guidance is incorporated in the new Interpretation. Guarantees of indebtedness are “indirect” if the creditor’s claim against the guarantor is based solely on the right to enforce the debtor’s claim against the guarantor.

Guarantees of an entity’s own performance are excluded from the scope of the Interpretation, as are guarantees of funding, such as commercial letters of credit and other loan commitments, and subordination arrangements, where one class of investors agrees not to receive any cash until investors in a priority class are paid. A lessee’s residual value guarantee under a capital lease is also excluded from the scope of the Interpretation (since the leased asset accounted for on the books of the lessee includes the value of the guarantee) but not a lessee’s residual value guarantee under an operating leases, which is an executory contract. The Interpretation’s exclusions are given in the nearby table.

Excluded from the entire Interpretation	Excluded solely from the initial recognition requirements (disclosure only)
<ul style="list-style-type: none"> ■ Guarantees that are excluded from the scope of Statement 5 (for example, pensions and stock options); ■ Residual value guarantees issued by a lessee that accounts for a lease as a capital lease; ■ Guarantees issued by either an insurance or a reinsurance company and accounted for under specified FASB Statements; ■ Guarantees that require payments due to changes in an underlying that belongs to the guaranteed party, but: <ul style="list-style-type: none"> – are accounted for as contingent rents, or – provide vendor rebates by the guarantor based on either the sales revenues of or the number of units sold by the guaranteed party; ■ Guarantees that prevent the guarantor from accounting for a transaction as a sale or recognizing the profit from that sale transaction in earnings. 	<ul style="list-style-type: none"> ■ Guarantees that are accounted for under Statement 133 as a derivative instrument at fair value; ■ Contracts that guarantee the functionality of nonfinancial assets that are owned by the guaranteed party (e.g., product warranties); ■ Contracts that require contingent consideration in a business combination; ■ Guarantees issued by an original lessee that has become secondarily liable under a new lease that relieved the original lessee of the primary obligation under the original lease; ■ Guarantees issued either between parents and their subsidiaries or corporations under common control; ■ Guarantees by a parent of its subsidiary's debts to third parties; ■ Guarantees by a subsidiary of debts owed to third parties by either its parents or other subsidiaries of that parent.

(2) The GAAP definition of an “underlying” is in paragraph 540 of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, June 1998.

(3) FASB Interpretation No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others, March 1981.

The distinctions between kinds of guarantees that are or are not subject to the Interpretation can become a challenge, creating needs for difficult judgments in determining the applicability of the Interpretation. For example, companies will have to understand the distinction between a standby letter of credit, which is covered by the Interpretation, and a commercial letter of credit, which is not. Of the two, only the financial standby letter of credit is irrevocable and both guarantees payment and provides for payment based on changes in an underlying. Guarantees are generally excluded from the scope of the Interpretation if the accounting for the guarantee contract is covered by existing GAAP.

INITIAL RECOGNITION AND MEASUREMENT

According to the Interpretation, guarantors have two distinct obligations: a non-contingent, immediate obligation to stand ready to perform (the “stand-ready obligation”), and a contingent obligation to make future payments depending on whether specific conditions occur. The distinction between the two obligations is fundamental to the Interpretation’s requirements. Guarantors must recognize a liability for the stand-ready obligation at the inception of the guarantee. The Interpretation addresses the accounting for the stand-ready obligation. The contingent obligation should be recognized and measured as directed by Statement 5.⁴

The premium to be received by the guarantor is the fair value of the guarantor’s stand-ready liability if the guarantee is issued to an unrelated party in a single-element transaction. In more complex transactions with multiple elements, estimating the fair value of the stand-ready obligation is expected to be challenging. A specified premium payment for a guarantee embedded in a multi-element transaction might not be an appropriate initial measurement for the stand-ready obligation, because the payment might not represent the fair value of the stand-ready obligation.

The requirement to determine the fair value of all guarantees, not just those for which a stated premium was received, could present significant implementation difficulties. The Interpretation provides little guidance on determining the fair

value of the stand-ready liability, offering the expected present value approach as a valuation option. Expected present value, in the FASB’s words, “refers to the sum of the probability-weighted present values in a range of estimated cash flows, all discounted using the same interest rate convention.”⁵

The account offsetting the liability recognized at the inception of a guarantee will be determined by the circumstances and nature of the guarantee. If a guarantee is issued in connection with the formation of a joint venture, for example, the offsetting entry to the liability would probably be the investment in the joint venture. To take another example, the offsetting entry for a lessee-guarantor’s residual-value guarantee under an operating lease would probably be prepaid rent, representing the lessee’s initial payment made when entering the lease.

“DAY TWO” ACCOUNTING

The Interpretation says that the guarantor’s stand-ready liability would typically be reduced by a credit to earnings as the guarantor is released from risk under the guarantee and cites these three typical methods to do so:

- At the expiration or settlement of the guarantee, reverse the liability by a credit to earnings.
- Reduce the liability and credit earnings by a systematic and rational amortization method if the maximum potential amount of future payments will be reduced over the term of the guarantee.
- Reduce the liability by the changes in the fair value of the guarantee.

The initial selection of one of these methods is an accounting policy election.

The Interpretation is unclear about the interaction between the stand-ready liability and any liability accrued, pursuant to Statement 5, for probable payments. We believe that in practice

(4) FASB Statement No. 5, *Accounting for Contingencies*, March 1975.

(5) FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, February 2,000 Glossary.

each of the two liabilities would be accounted for independently, potentially resulting in a credit to earnings for release from the stand-ready component associated with the guarantee and a charge to earnings for the estimated liability incurred for probable payments under the guarantee.

DISCLOSURE

The Interpretation's disclosure requirements are likely to impose the greatest implementation burden. New disclosures are required for most guarantees, including product warranty arrangements, whether or not the likelihood that the guarantor will have to make any payments is remote. The disclosures below, which are required for interim as well as annual financial statements, add to those required by Statement 5:

- The circumstances that gave rise to the guarantee and the conditions that require the guarantor to make payments under the guarantee.
- Except for product warranties, the maximum potential amount of future payments (undiscounted) under the guarantee. If the guarantor cannot estimate the amount, the reason should be disclosed.
- The carrying amount of the guarantor's contingent and non-contingent obligation under the guarantee.
- The nature and extent of recourse provisions and collateral related to the guarantee and, if estimable, the extent to which the maximum potential loss under the guarantee would be covered.
- The fair value of financial guarantees.

The Interpretation's disclosure requirements apply also to guarantees issued to benefit entities defined as related parties by Statement 57 and to "certain entities for which the controlling financial interest cannot be assessed by analyzing voting interests." This would include entities within the scope of the FASB's proposed pronouncement on consolidating special purpose entities. For such entities, Interpretation 45's disclosure requirements would add to Statement 57's.⁶

Guarantors are not required to disclose the maximum potential amount of future payments for product warranties and similar arrangements. Instead, the disclosures for such arrangements should include the accounting policy and methodology used in calculating the liability and a tabular reconciliation of the changes in that liability for the reporting period.

Quantitative data included in the disclosures (e.g., maximum potential amount of future payments, coverage rate of recourse provisions and collaterals, fair values) will have to be updated for each set of annual and interim financial statements. This may call for running detailed analyses to determine changes in circumstances related to a guarantee.

SEC registrants cannot assume that the Interpretation's disclosure requirements preclude related disclosures in MD&A.

Such companies should evaluate their obligations under FR-61 and the SEC's proposal on disclosing off-balance-sheet arrangements.⁷

Update on the Amendment to Statement 123

The FASB is expected to issue at the end of this month its Statement to provide two additional transition alternatives for companies that voluntarily adopt the fair-value measurement provisions of Statement 123 and expanded disclosures for stock-based compensation arrangements.* Recent deliberations led to a decision to subject the prospective transition method already in Statement 123 to a sunset provision. The method would not be available for companies that voluntarily adopt Statement 123 for fiscal periods beginning after December 15, 2003.

* FASB Statement 123, Accounting for Stock-Based Compensation, October 1995.

EFFECTIVE DATE

The initial recognition and initial measurement requirements of the Interpretation are effective prospectively for guarantees issued or modified after December 31, 2002. However, the disclosure requirements are effective for financial-statement periods ending after December 15, 2002, thereby covering guarantees in

(6) FASB Statement No. 57, Related Party Disclosures, March 1982.

(7) SEC Releases No. 33-8056, Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations, and No. 33-8144, Disclosure in Management's Discussion and Analysis About Off-Balance-Sheet Arrangements.



place as of the balance-sheet date. This means the calendar-year companies will have to make the disclosures for their December 31, 2002 financial statements. It also means that some companies will have to develop processes to identify embedded guarantees in arrangements entered into prior to December 31, 2002.

Revision or restatement of the guarantor's previous accounting for guarantees issued prior to the date of the Interpretation's initial application is prohibited.

The descriptive and summary statements in this presentation are not intended to substitute for the text of Interpretation 45's requirements. All relevant facts and circumstances should be evaluated to arrive at accounting that complies with Interpretation 45. Persons who apply the Interpretation may want to consult their accounting advisors.

Additional information on how to implement Interpretation 45 is available from your local KPMG representative or office.

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