Introduction

On November 25, 2002, the Financial Accounting Standards Board (The Board) issued FASB Interpretation No. 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. The Interpretation expands on the accounting guidance in the following documents:

- FASB Statement No. 5, Accounting for Contingencies (FAS 5)
- FASB Statement No. 57, Related Party Disclosures
- FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments

The new Interpretation also incorporates and supercedes the provisions of FASB Interpretation No. 34, Capitalization of Interest Cost.

In a Nutshell

Interpretation No. 45 clarifies the requirements of FAS 5 relating to the guarantor’s accounting for and disclosure of the issuance of certain types of guarantees. It also significantly modifies current practices in the accounting for and disclosure of guarantees.

The Interpretation requires certain guarantees to be recorded at fair value. This differs from the current practice, which is generally to record a liability only when a loss is probable and reasonably estimable (as defined in FAS 5).

The Interpretation also requires a guarantor to make significant new disclosures, even when the likelihood of making any payments under the guarantee is remote (another change from current practice).

Background

FASB Interpretation No. 45 resulted from discussions related to the Board’s consolidations project, the purpose of which is to develop comprehensive accounting guidance on accounting affiliations between entities.

The disclosure issue has received greater attention in light of the publicized failure of Enron to disclose the significant guarantees it had made. The Board noted that diversity in practice suggests confusion about exactly what disclosures guarantors are required to make and about the need for a guarantor to recognize an initial liability for its obligation under a guarantee.

FASB Interpretation No. 45 requires that, upon issuance of a guarantee, a guarantor must recognize a liability for the fair value of the obligation it assumes under that guarantee. The Board believes that, in current practice, many entities might not be recognizing an initial guarantee liability.

On the other hand, many guarantors believe that GAAP does not require such recognition, particularly when the entity does not receive separately identifiable consideration (such as a premium for issuing the guarantee).

The Scope of FASB Interpretation No. 45

The Interpretation uses a characteristic-based definition of a guarantee to determine whether a contract or agreement is included in its scope. While the provisions address “stand-alone” guarantees, many in the accounting profession believe they apply to other contract guarantees, as well.

Except for the specific scope exceptions described later, the Interpretation’s provisions apply to guarantee contracts that have any of the following characteristics:
• Financial Guarantees: Contracts that contingently require the guarantor to make payments to the guaranteed party based on changes in an underlying related to an asset, liability, or an equity security of the guaranteed party;

• Performance Guarantees: Contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity’s failure to perform under an obligating agreement;

• Indemnifications: Agreements that contingently require the guarantor to make payments to an indemnified party based on changes in an underlying related to an asset, liability, or an equity security of the indemnified party; or

• Indirect guarantees of the indebtedness of others.

Pursuant to the Interpretation, “payments” can be in the form of cash, financial instruments, shares of the guarantor’s own equity instruments, other assets, or provision of services.

**Global Exclusions**

The following are excluded from the entire Interpretation:

• Guarantees that are excluded from the scope of FAS 5 (for example, pensions and stock options);

• Residual value guarantees issued by a lessee that account for a lease as a capital lease;

• Guarantees that are issued by either an insurance or a reinsurance company and are accounted for under specified FASB Statements;

• Guarantees that prevent the guarantor from accounting for a transaction as a “sale” or recognizing the profit from that sale transaction in earnings; and

• Guarantees that require payments due to changes in an underlying that belongs to the guaranteed party, but:
  – 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.

**Specific Exclusions**

The following are excluded solely from the initial recognition requirements, but are still subject to disclosure requirements:

• Guarantees that are accounted for under FAS 133 as derivative instruments at fair value;

• Contracts that guarantee the functionality of non-financial assets owned by the guaranteed party (such as product warranties);

• Contracts that require contingent consideration in a business combination;

• Guarantees issued by an original lessee that become secondarily liable under a new lease because the new lease relieves the original lessee of the primary obligation under the original lease;

• Guarantees issued between parents and their subsidiaries or between corporations under common control;

• Guarantees by a parent of its subsidiary’s debts to third parties; and

• Guarantees by a subsidiary of debts owed to third parties by either its parents or other subsidiaries of that parent.

**Initial Recognition & Measurements**

At the inception of a guarantee, the guarantor is required to recognize a liability for that guarantee in its statement of financial position. Except for situations in which the guarantor is required to recognize a liability under FAS 5 for the related contingent loss (as described later), the liability shall be measured initially at its fair value.

**Initial Recognition**

When issued in a stand-alone, arm’s-length transaction with an unrelated party, the liability recognized at the inception of the guarantee would generally be equal to the premium received (or receivable) by the guarantor. In many situations, however, a guarantee is issued as part of a “multiple element exchange” transaction with an unrelated party. In those situations, guarantors should consider what the premium would have been had the guarantee been issued in a stand-alone transaction.

**Expected Present Value & Other Issues**

Because quoted prices in active markets are not likely to be available, and due to the lack of a secondary market for most guarantee arrangements, many entities will be required to estimate the fair value of a guarantee obligation based on the expected present value of contingent payments under the guarantee arrangement.

FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements, states in its glossary that, “expected present value refers to the sum of probability-weighted present values in a range of estimated cash flows, all discounted using the same interest rate convention.” The general principles of Concepts Statement 7 should be applied to guarantees to compute fair value.

In some cases, a liability may need to be recognized under FAS 5 when the guarantee is issued. In that case, the initial liability to be recognized for the guarantor’s obligation under
the guarantee should be the greater of either fair market value or the liability amount required by FAS 5 to be recognized at the inception of the guarantee.

Accounting Mechanics
While the Interpretation provides guidance on the initial recognition and initial measurement of the guarantee liability, it does not describe in detail the guarantor's offsetting entry when it recognizes that liability. Consequently, the business purpose of each transaction must be carefully analyzed and the accounting for each transaction should be based on the individual facts and circumstances. The chart on the next page illustrates how the initial offsetting entry will depend on the circumstances in which the guarantee was issued.

For example: ABC Construction, a general contractor, is required to give a performance guarantee to make payments to the contract owner based on its subcontractor's failure to perform under an obligating agreement. So, ABC Construction obtains a performance standby letter of credit, which is an irrevocable undertaking by a guarantor to make payment in the event a specified third party fails to perform under a non-financial contractual obligation.

Under this construction completion guarantee, ABC Construction is subject to the recognition and disclosure requirements under this Interpretation. The guarantee was issued as a stand-alone non-reciprocal transfer, so the offsetting debit is to expense.

Subsequent Measurement
The Interpretation does not prescribe how the guarantor's liability for its obligations under the guarantee should be measured subsequent to initial recognition. However, it does recognize that, in subsequent periods, the initial liability would typically be reduced by a credit to earnings as the guarantor is released from risk under the guarantee.

Depending on the nature of the guarantee, the guarantor's release from risk under current GAAP has typically been recognized over the term of the guarantee as follows:
- Only upon expiration or settlement of the guarantee;
- By a systematic and rational amortization method; or
- As the fair value of the guarantee changes on a market-to-market basis (for example, for guarantees accounted for as derivatives under FAS 133).

Note: The accounting for the initial obligation does not encompass the recognition and subsequent adjustment of any contingent liability recognized under FAS 5 related to any contingent loss resulting from the guarantee.

Disclosures
With a limited exception for product warranties, the Interpretation requires guarantors to provide the following for each guarantee (or each group of similar guarantees), even when the likelihood of the guarantor's having to make payments is remote:
- The nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events or circumstances that would require the guarantor to perform under the guarantee;
- The maximum potential amount of undiscounted future payments the guarantor could be required to make under the guarantee;
- The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee (including the amount, if any, recognized under FAS 5), regardless of whether the guarantee is freestanding or embedded in another contract; and
- The nature of:
  - Any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee; and
  - Any assets held either as collateral or by third parties that the guarantor can, upon occurrence of any triggering event or condition under the guarantee, obtain and liquidate to recover all or a portion of the amounts paid under the guarantee.

The approximate extent, if estimable, to which the proceeds from liquidation of collateral would be expected to cover the maximum potential amount of future payments under the guarantee must also be disclosed.

Product Warranties
Disclosure of the maximum potential amount of future payments is not required for product warranties and other guarantee contracts for which the underlying is related to the functional performance (rather than price) of non-financial assets owned by the guaranteed party.

Instead, the following information regarding product warranties must be disclosed:
- The guarantor's accounting policy and the methodology used in determining its liability for product warranties (including any liability associated with extended warranties, such as deferred revenue); and
- A tabular reconciliation of the changes in the guarantor's product warranty liability for the reporting period.
An Overreaction?

Critics say the Interpretation overcompensates for the damage done by a few offenders. Many view it as an overreaction, charging that companies must now record a liability even though they are simply guaranteeing another entity’s liability.

But, such criticism is muted by the fact that the changes are applied judiciously, not across-the-board. As noted in this article, they do not apply to product warranties and guarantees accounted for as derivatives under FAS 133. They also do not apply to certain other types of guarantee contracts, such as those issued by insurance companies.

Conclusion

In commenting about the importance of the Interpretation to investors, FASB Senior Project Manager Robert C. Wilkins noted that it will help provide a more faithful representation of a company’s financial position and the risk it has assumed. This should significantly improve the reporting of guarantees issued in conjunction with other transactions, such as when a seller also guarantees its customer’s repayment of the funds borrowed to pay the seller for the customer’s purchases.

The initial recognition and measurement requirements apply to guarantees issued or modified after December 31, 2002, regardless of the guarantor’s fiscal year-end. Disclosure requirements are effective for financial statements or interim annual periods ending after December 12, 2002.

Endnote

1. An underlying is a variable, such as a specified interest rate or securities price. FASB Interpretation No. 45 states that an underlying includes the occurrence or non-occurrence of a specific event, such as a scheduled payment under a contract. (The GAAP definition of an “underlying” can be found in paragraph 540 of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, June 1998.)

This makes it 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.

Examples of Guarantees and Offsets

<table>
<thead>
<tr>
<th>GUARANTEE ISSUANCE</th>
<th>OFFSETTING DEBIT</th>
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<tbody>
<tr>
<td>Stand-alone exchange transaction for a premium with an unrelated party.</td>
<td>Consideration received (for example, cash or receivable).</td>
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<tr>
<td>In conjunction with the sale of assets, a product, or a business.</td>
<td>Overall proceeds (for example, cash received or receivable) would be allocated between the consideration being remitted to the guarantor for issuing the guarantee and the proceeds from the sale. The allocation will affect the calculation of the gain or loss on the sale transaction.</td>
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<td>In connection with the formation of a partially owned enterprise or venture accounted for under the equity method.</td>
<td>An increase in the investor’s carrying amount of the investment.</td>
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<td>Residual value guarantee in connection with an operating lease.</td>
<td>Recognized as a prepaid rent (that is, the guarantee obligation is considered part of the lessee’s initial payment) and amortized on a straight-line basis over the term of the lease.</td>
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<tr>
<td>In a stand-alone, non-reciprocal transfer for no consideration.</td>
<td>Expense.</td>
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