FASB Interpretation No. 45

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FIN 45 Summary

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

Financial Accounting Standards Board
of the Financial Accounting Foundation
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FIN 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

FIN 45 Summary

This Interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. This Interpretation does not prescribe a specific approach for subsequently measuring the guarantor's recognized liability over the term of the related guarantee. This Interpretation also incorporates, without change, the guidance in FASB Interpretation No. 34, *Disclosure of Indirect Guarantees of Indebtedness of Others,* which is being superseded.

This Interpretation does not apply to certain guarantee contracts: guarantees issued by insurance and reinsurance companies and accounted for under accounting principles for those companies, residual value guarantees provided by lessees in capital leases, contingent rents, vendor rebates, and guarantees whose existence prevents the guarantor from recognizing a sale or the earnings from a sale. Furthermore, the provisions related to recognizing a liability at inception for the fair value of the guarantor's obligation do not apply to the following:

a. Product warranties
b. Guarantees that are accounted for as derivatives
c. Guarantees that represent contingent consideration in a business combination
d. Guarantees for which the guarantor's obligations would be reported as an equity item (rather than a liability)
e. An original lessee's guarantee of lease payments when that lessee remains secondarily liable in conjunction with being relieved from being the primary obligor (that is, the principal debtor) under a lease restructuring
f. Guarantees issued between either parents and their subsidiaries or corporations under common control

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g. A parent's guarantee of a subsidiary's debt to a third party, and a subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

However, the guarantees described in (a)–(g) above are subject to the disclosure requirements of this Interpretation.

Reason for Issuing This Interpretation

The Board has observed that there are differing interpretations about the disclosures required of guarantors under FASB Statement No. 5, *Accounting for Contingencies,* and about the need for a guarantor to recognize an initial liability for its obligation under a guarantee. Some constituents believe that Statement 5 prohibits the guarantor from initially recognizing a liability for a guarantee issued unless it is probable that payments will be required under that guarantee. This Interpretation clarifies the requirements of Statement 5 relating to the guarantor's accounting for and disclosures of certain guarantees issued.

Differences between This Interpretation and Current Practice

This Interpretation clarifies that a guarantor is required to disclose (a) 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; (b) the maximum potential amount of future payments under the guarantee; (c) the carrying amount of the liability, if any, for the guarantor's obligations under the guarantee; and (d) the nature and extent of any recourse provisions or available collateral that would enable the guarantor to recover the amounts paid under the guarantee. For product warranties, instead of disclosing the maximum potential amount of future payments under the guarantee, a guarantor is required to disclose its accounting policy and methodology used in determining its liability for product warranties as well as a tabular reconciliation of the changes in the guarantor's product warranty liability for the reporting period. Disclosures under current practice, which generally include only the nature and amount of guarantees, do not provide the same level of useful information as required by this Interpretation.

This Interpretation also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for 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 specified triggering events or conditions occur. The objective of the initial measurement of that liability is the fair value of the guarantee at its inception. The Board believes that, in current practice, many entities may not be recognizing a liability for a guarantee because the recognition requirements in Statement 5 (pertaining to loss contingencies) have not been met at the inception of the guarantee and the premium for the guarantee was not separately identified because it was embedded in purchase or sales agreements, service contracts, joint venture agreements, or other commercial agreements.

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How the Changes in This Interpretation Improve Financial Reporting

The recognition of a liability for the obligations undertaken upon issuing a guarantee results in a more representationally faithful depiction of the guarantor's assets and liabilities. When a guarantee is issued without a separately identified premium in conjunction with another transaction, the gain or loss recognized on that other transaction would be misstated if the guarantor fails to recognize a liability for the guarantee. For example, if a seller-guarantor issues to its customer's bank a guarantee of the customer's loan to facilitate the customer's obtaining funds to pay the seller for the assets being purchased, the failure to recognize a liability for the issuance of the guarantee overstates the profit on the sale. In those circumstances, the recognition of the liability for the guarantee results in a more representationally faithful depiction of the seller-guarantor's liabilities and results of operations. The initial recognition and initial measurement requirements in this Interpretation are expected to affect primarily the accounting for multiple-element transactions that include issuance of a guarantee by one party to the other.

The disclosures required by this Interpretation improve the transparency of the financial statement information about the guarantor's obligations and liquidity risks related to guarantees issued.

How the Conclusions in This Interpretation Relate to the Conceptual Framework

FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* states that financial reporting should provide information to help users assess the amounts, timing, and uncertainty of the guarantor's prospective net cash flows. The disclosures about and the initial recognition of guarantees will provide that information. The guarantor's recognition of a liability at the inception of a guarantee for the obligations it has undertaken in issuing the guarantee is consistent with the definition of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements,* which states that "responsibilities such as those to . . . honor warranties and guarantees also create liabilities under the definition" (paragraph 196).

The Effective Date of This Interpretation

The initial recognition and initial measurement provisions of this Interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The disclosure requirements in this Interpretation are effective for financial statements of interim or annual periods ending after December 15, 2002. The interpretive guidance incorporated without change from Interpretation 34 continues to be required for financial statements for fiscal years ending after June 15, 1981—the effective date of Interpretation 34.

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INTRODUCTION

1. The Board observed differences in interpretation about the disclosures required of issuers of guarantees and about the need for an issuer of a guarantee to recognize an initial liability for its obligations under the guarantee. This Interpretation clarifies the requirements for a guarantor's accounting for and disclosures of certain guarantees issued and outstanding. This Interpretation also incorporates without reconsideration the guidance in FASB Interpretation No. 34, *Disclosure of Indirect Guarantees of Indebtedness of Others,* which is being superseded.

SCOPE

2. This Interpretation addresses the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees. This Interpretation also clarifies the requirements related to the recognition of a liability by a guarantor at the inception of a guarantee for the obligations the guarantor has undertaken in issuing that guarantee. As discussed in paragraph 12, this Interpretation does not specify the subsequent measurement of the guarantor's recognized liability for either the noncontingent aspect of the guarantee or the contingent aspect of the guarantee. The accounting for the contingent aspect of the guarantee, if it is not accounted for as a derivative under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* is covered by FASB Statement No. 5, *Accounting for Contingencies*. The provisions in Statement 5 about disclosure of a loss that is reasonably possible are not affected by this Interpretation.

3. Except as provided in paragraphs 6 and 7, the provisions of this Interpretation apply to guarantee contracts that have any of the following characteristics:

a. Contracts that contingently require the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, [1] or provision of services) to the guaranteed party based on changes in an underlying [2] that is related to an asset, a liability, or an equity security of the guaranteed party. Thus, for example, the provisions apply to the following:
   (1) A financial standby letter of credit, which is an irrevocable undertaking (typically by a financial institution) to guarantee payment of a specified financial obligation
   (2) A market value guarantee on either a financial asset (such as a security) or a nonfinancial asset owned by the guaranteed party
   (3) A guarantee of the market price of the common stock of the guaranteed party
   (4) A guarantee of the collection of the scheduled contractual cash flows from individual financial assets held by a special-purpose entity (SPE).
b. Contracts that contingently require the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, or provision of services) to the guaranteed party

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based on another entity's failure to perform under an obligating agreement (performance guarantees). Thus, for example, the provisions apply to a performance standby letter of credit, which is an irrevocable undertaking by a guarantor to make payments in the event a specified third party fails to perform under a nonfinancial contractual obligation.

c. Indemnification agreements (contracts) that contingently require the indemnifying party (guarantor) to make payments to the indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party, such as an adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law.
d. Indirect guarantees of the indebtedness of others, as that phrase is used in paragraphs 17 and 18 (and originally in Interpretation 34), even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

4. Commercial letters of credit and other loan commitments, which are commonly thought of as guarantees of funding, are not included in the scope of this Interpretation because those arrangements do not meet any of the four characteristics identified in paragraph 3 above. Similarly, the scope of this Interpretation does not encompass indemnifications or guarantees of an entity's own future performance (for example, a guarantee that the guarantor will not take a certain future action). It does not include a noncontingent forward contract for which the net settlement can flow from either party to the other party; however, a contingent forward contract may meet one of the characteristics in paragraph 3 and be included in the scope of this Interpretation.

5. Some securitizations and other arrangements involve the subordination of the rights of some investors (or creditors) to the rights of others, in which case, for example, the investors in one (subordinated) class or tranche of an entity's securities might not receive any cash flows until the investors in another (priority) class or tranche are fully paid. Because that type of subordination provides credit protection by the subordinated investors, those subordination arrangements are commonly thought of as guarantees issued by the subordinated investors. Such subordination arrangements do not meet the characteristic-based scope provisions in paragraph 3 and, thus, are not included in the scope of this Interpretation. [3]

Scope Exceptions from the Entire Interpretation

6. Notwithstanding the characteristic-based scope provisions in paragraph 3, this Interpretation does not apply to the following guarantee contracts:

a. A guarantee or an indemnification that is excluded from the scope of Statement 5 under paragraph 7 of that Statement.
b. A lessee's guarantee of the residual value of the leased property at the expiration of the lease term, if the lessee (guarantor) accounts for the lease as a capital lease under FASB

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Statement No. 13, *Accounting for Leases.*

c. A contract that meets the characteristics in paragraph 3(a) but is accounted for as contingent rent under Statement 13.

d. A guarantee (or an indemnification) that is issued by either an insurance company or a reinsurance company and accounted for under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* or No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts* (including guarantees embedded in either insurance contracts or investment contracts).

e. A contract that meets the characteristics in paragraph 3(a) but provides for payments that constitute a vendor rebate (by the guarantor) based on either the sales revenues of, or the number of units sold by, the guaranteed party. (Vendor rebates based on the volume of purchases by the buyer would not meet the characteristics in paragraph 3(a) because the underlying relates to an asset of the seller, not the buyer who receives the rebates.)

f. A guarantee (or an indemnification) whose existence prevents the guarantor from being able to either account for a transaction as the sale of an asset that is related to the guarantee's underlying or recognize in earnings the profit from that sale transaction.

Scope Exceptions from Only the Initial Recognition and Initial Measurement Provisions

7. The following types of guarantees are not subject to the initial recognition and initial measurement provisions of this Interpretation but are subject to its disclosure requirements:

a. A guarantee that is accounted for as a derivative instrument at fair value under Statement 133.

b. A guarantee for which the underlying is related to the performance (regarding function, not price) of nonfinancial assets that are owned by the guaranteed party. Thus, the initial recognition and initial measurement provisions of this Interpretation do not apply to product warranties issued by the guarantor, regardless of whether the guarantor is required to make payment in services or cash, including separately priced extended warranty or product maintenance contracts that are addressed in FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts.*

c. A guarantee issued in a business combination that represents contingent consideration (as addressed in FASB Statement No. 141, *Business Combinations*).

d. A guarantee for which the guarantor's obligation would be reported as an equity item (rather than a liability) under generally accepted accounting principles (GAAP).

e. A guarantee by an original lessee that has become secondarily liable under a new lease that relieved the original lessee from being the primary obligor (that is, principal debtor) under the original lease, as discussed in paragraph 38 of Statement 13, as amended by FASB

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Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections.* This exception shall not be applied by analogy to secondary obligations that are not accounted for under paragraph 38 of Statement 13. (The disclosure requirements of this Interpretation do apply to the original lessee that has become secondarily liable for the lease payments.)

f. A guarantee issued either between parents and their subsidiaries or between corporations under common control.
g. A parent's guarantee of its subsidiary's debt to a third party (whether the parent is a corporation or an individual).
h. A subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

INTERPRETATION

Initial Recognition and Initial Measurement of the Liability for a Guarantor's Obligations

8. The issuance of a guarantee obligates the guarantor (the issuer) in two respects: (a) the guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect) and (b) the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect).

9. Because the issuance of a guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering events or conditions occur, the provisions of paragraphs 8–12 of Statement 5 regarding the guarantor's contingent obligation under a guarantee should not be interpreted as prohibiting the guarantor from initially recognizing a liability for that guarantee even though it is *not* probable that payments will be required under that guarantee. At the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee. Except as indicated in paragraph 10, the objective of the initial measurement of the liability is the fair value of the guarantee at its inception.

a. When a guarantee is issued in a standalone arm's-length transaction with an unrelated party, the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor.
b. When a guarantee is issued as part of a transaction with multiple elements with an unrelated party (such as in conjunction with selling an asset or entering into an operating lease), the liability recognized at the inception of the guarantee should be an estimate of the guarantee's fair value. In that circumstance, guarantors should consider what premium

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would be required by the guarantor to issue the same guarantee in a standalone arm's-length transaction with an unrelated party. In the absence of observable transactions for identical or similar guarantees, expected present value measurement techniques as set forth in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* will likely provide the best estimate of fair value. Concepts Statement 7 states in its glossary that "*expected present value* 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." The general principles in paragraph 41 of Concepts Statement 7 are also relevant.

c. When a guarantee is issued as a contribution to an unrelated party, the liability recognized at the inception of the guarantee should be measured at its fair value, consistent with the requirement to measure the contribution made at fair value, as prescribed in paragraph 18 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*. For example, a community foundation may have a loan guarantee program to assist not-for-profit organizations in obtaining bank financing at a reasonable cost. Under that program, the community foundation may issue a guarantee of a not-for-profit organization's bank debt. Upon the issuance of the guarantee, the community foundation would recognize a liability for the fair value of that guarantee. The issuance of that guarantee would not be considered merely a *conditional promise to give* under paragraph 22 of Statement 116 because, upon the issuance of the guarantee, the not-for-profit organization will have received the gift of the community foundation's credit support, which enables the not-for-profit organization to obtain a lower interest rate on its borrowing.

10. In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under Statement 5 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of (a) the amount that satisfies the fair value objective as discussed in paragraph 9 or (b) the contingent liability amount required to be recognized at inception of the guarantee by paragraph 8 of Statement 5. For many guarantors, it would be unusual for the contingent liability amount under (b) above to exceed the amount that satisfies the fair value objective under (a) above at the inception of the guarantee. [4]

11. This Interpretation does not prescribe a specific account for the guarantor's offsetting entry when it recognizes the liability at the inception of a guarantee. That offsetting entry depends on the circumstances in which the guarantee was issued, as illustrated by the following examples:

a. If the guarantee were issued in a standalone transaction for a premium, the offsetting entry would be consideration received (such as cash or a receivable).

b. If the guarantee were issued in conjunction with the sale of assets, a product, or a business, the overall proceeds (such as the 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. That allocation would affect the calculation of the gain or loss on the sale transaction.

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c. If the guarantee were issued in conjunction with the formation of a partially owned business or a venture accounted for under the equity method, the recognition of the liability for the guarantee would result in an increase to the carrying amount of the investment.
d. If a residual value guarantee were provided by a lessee-guarantor when entering into an operating lease, the offsetting entry (representing a payment in kind made by the lessee when entering into the operating lease) would be reflected as prepaid rent, which would be accounted for under paragraph 15 of Statement 13.
e. If a guarantee were issued to an unrelated party for no consideration on a standalone basis (that is, not in conjunction with any other transaction or ownership relationship), the offsetting entry would be to expense.

12. This Interpretation does not describe in detail how the guarantor's liability for its obligations under the guarantee would be measured subsequent to its initial recognition. The liability that the guarantor initially recognized under paragraph 9 consistent with the fair value objective discussed in that paragraph 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 has typically been recognized over the term of the guarantee (a) only upon either expiration or settlement of the guarantee, (b) by a systematic and rational amortization method, or (c) as the fair value of the guarantee changes (as is done, for example, for guarantees accounted for as derivatives). The discussion in this paragraph about how the guarantor typically reduces the liability that it initially recognized does not encompass the recognition and subsequent adjustment of the contingent liability recognized under Statement 5 related to the contingent loss for the guarantee.

Disclosures about a Guarantor's Obligations under Guarantees

13. A guarantor shall disclose the following information about each guarantee, or each group of similar guarantees, even if the likelihood of the guarantor's having to make any payments under the guarantee is remote, except as provided in paragraph 14 with respect to the disclosure specified in paragraph 13(b):

a. 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.
b. The maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the guarantee (which are addressed under (d) below). If the terms of the guarantee provide for no limitation to the maximum potential future payments under the guarantee, that fact shall be disclosed. If the guarantor is unable to develop an estimate of the maximum potential amount of future payments under its guarantee, the guarantor shall disclose the reasons why it cannot estimate the maximum

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potential amount. (Refer to the following paragraph for an exception to the requirements of this subparagraph.)

c. The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee (including the amount, if any, recognized under paragraph 8 of Statement 5), regardless of whether the guarantee is freestanding or embedded in another contract.
d. The nature of (1) any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee and (2) any assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee. The guarantor shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the guarantee.

14. For product warranties and other guarantee contracts that are excluded from the initial recognition and initial measurement requirements of this Interpretation pursuant to paragraph 7(b) (collectively referred to as product warranties), a guarantor is not required to disclose the maximum potential amount of future payments specified in paragraph 13(b) above. Instead, the guarantor is required to disclose for those product warranties the following information:

a. The guarantor's accounting policy and methodology used in determining its liability for product warranties (including any liability [such as deferred revenue] associated with extended warranties).
b. A tabular reconciliation of the changes in the guarantor's aggregate product warranty liability for the reporting period. That reconciliation should present the beginning balance of the aggregate product warranty liability, the aggregate reductions in that liability for payments made (in cash or in kind) under the warranty, the aggregate changes in the liability for accruals related to product warranties issued during the reporting period, the aggregate changes in the liability for accruals related to preexisting warranties (including adjustments related to changes in estimates), and the ending balance of the aggregate product warranty liability.

15. The disclosures required by this Interpretation do not eliminate or affect the requirement in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* as amended by FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities,* that certain entities disclose the fair value of their financial guarantees issued.

16. Some guarantees are issued to benefit entities that meet the definition of a related party in paragraph 24(f) of FASB Statement No. 57, *Related Party Disclosures,* such as joint ventures, equity method investees, and certain entities for which the controlling financial interest cannot be assessed by analyzing voting interests. In those cases, the disclosures required by this Interpretation are incremental to the disclosures required by Statement 57.

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Indirect Guarantees of Indebtedness of Others Encompassed by Paragraph 12 of Statement 5

17. An indirect guarantee of the indebtedness of another arises under an agreement that obligates one entity to transfer funds to a second entity upon the occurrence of specified events, under conditions whereby (a) the funds become legally available to creditors of the second entity and (b) those creditors may enforce the second entity's claims against the first entity under the agreement. Examples of indirect guarantees include agreements to advance funds if a second entity's net income, coverage of fixed charges, or working capital falls below a specified minimum.

18. The term *guarantees of indebtedness of others* in paragraph 12 of Statement 5 includes indirect guarantees of indebtedness of others as described in paragraph 17 of this Interpretation.

RESCISSION OF INTERPRETATION 34

19. Interpretation 34 is superseded by this Interpretation.

EFFECTIVE DATE AND TRANSITION

20. The initial recognition and initial measurement provisions in paragraphs 9 and 10 shall be applied only on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The guarantor's previous accounting for guarantees issued prior to the date of this Interpretation's initial application shall not be revised or restated to reflect the effect of the recognition and measurement provisions of the Interpretation.

21. The disclosure requirements in paragraphs 13–16 are effective for financial statements of interim or annual periods ending after December 15, 2002. The guidance on indirect guarantees of the indebtedness of others in paragraph 18 continues to apply to financial statements for fiscal years ending after June 15, 1981.

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This Interpretation was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Messrs. Foster and Wulff dissented.

This Interpretation clarifies that guarantees are required to be recognized in the financial statements and measured initially at fair value. However, the Board has concluded that for a special class of guarantees—product warranties—that accounting is not required. Current practice measures the liability for product warranties at an estimated cost necessary to satisfy claims that are probable of having occurred under the warranty. That measure differs from fair value. A principal tenet of high-quality financial reporting—a tenet so important that it is set forth in the Board's Mission Statement—is that similar transactions should be accounted for similarly. Yet, the Board has chosen to tolerate very different accounting for transactions that are almost identical. Mr. Foster, while otherwise supporting the issuance of this Interpretation because it appropriately addresses other guarantees, believes that decision is inappropriate and consequently dissents from this Interpretation.

Mr. Foster also objects to the transition provisions. In accordance with the tenet that similar transactions should be accounted for similarly, he believes the initial recognition and initial measurement provisions of this Interpretation also should be applied to guarantees existing at December 31, 2002.

Mr. Wulff dissents from the issuance of this Interpretation. He believes that application of fair value measurements to guarantees that are not sold separately will result in unreliable initial measurements for those guarantees. Further, he notes that the effort involved in identifying and attempting to value embedded guarantees and indemnities will generate significant incremental costs. He supports the disclosure requirements of this Interpretation and observes that the new disclosures, alone, will address most user concerns in a cost-effective fashion. He believes that the Board has failed to make a reasonable quantitative or even qualitative case demonstrating that the added benefits of initial fair value recognition and measurement justify the additional costs associated with this change in practice.

When guarantees are priced and sold separately, initial recognition and initial measurement is not an issue. The guarantee premium received in an arm's-length negotiation is its fair value. Mr. Wulff understands that current practice has, for some time, supported the initial recognition of separately priced guarantees, measured at the premium received. In contrast, guarantees (other than derivatives) embedded in multiple-element commercial arrangements typically have not been initially recognized and measured at fair value. This difference in reporting reflects legitimate concerns about the reliability of fair value measurements of embedded guarantees and indemnities, in the absence of observable transaction prices. The Board has on numerous occasions acknowledged those concerns, noting that extension of fair value measurement is dependent on resolution of conceptual and practical issues related to valuation.

While agreeing that, in concept, fair value represents the most relevant measurement attribute of financial instruments, Mr. Wulff believes that fair value measurement requirements should not be applied to guarantees that are written as elements of multiple-element commercial arrangements, until the Board is able to conclude that measurement techniques exist to provide

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consistently reliable measurements. To do otherwise contributes to undermining the credibility of financial reporting. He believes, for example, that the inherent measurement error associated with guarantees of remote but high-exposure contingencies (such as many tax indemnities) may well exceed their calculated fair value. In such situations, this Interpretation will result in fair value measurements that are not verifiable, are subject to bias, and are not representationally faithful.

Members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
G. Michael Crooch
John M. Foster
Gary S. Schieneman
Katherine Schipper
Edward W. Trott
John K. Wulff

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Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix A: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction and Objective

A1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Interpretation. It includes summaries of the views presented by constituents in their comment letters on the Exposure Draft. It also includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

A2. The objective of this Interpretation is to improve the transparency of a guarantor's financial reporting about the obligations and risks arising from issuing guarantees with regard to two aspects:

a. To improve the informativeness of disclosures required by Statement 5 about the nature and amount of guarantees in the financial statements of guarantors
b. To clarify the requirement for initial recognition of a liability for the obligation incurred by a guarantor in issuing a guarantee, thereby improving the comparability of financial reporting for guarantees issued *with* a separately identified premium and guarantees issued *without* a separately identified premium.

A3. This Interpretation also supersedes Interpretation 34 and incorporates its guidance without reconsideration into the provisions of this Interpretation.

Background Information

A4. The Board's decision to undertake a project on guarantees was made in conjunction with its discussion of interpretive guidance related to identifying and accounting for entities for which the controlling financial interest cannot be assessed by analyzing voting interests. Guarantees are common in such situations and in other commercial arrangements. Diversity in practice suggests confusion about what disclosures are required to be made by the issuers of guarantees (guarantors) and about the need for the guarantor to recognize an initial liability for its obligations under the guarantee. Accordingly, the Board decided that a separate project was warranted to provide interpretive guidance relating to recognition and disclosures of guarantees by guarantors. This project was separated from the consolidations project at the February 13, 2002 Board meeting.

A5. In May 2002, the Board issued an Exposure Draft, *Guarantor's Accounting and*

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Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. The Board received 122 comment letters on the Exposure Draft. The Board discussed the Exposure Draft in meetings with constituents and the Financial Accounting Standards Advisory Council. The Board considered all comments and concerns raised by respondents and constituents during its redeliberations of the issues addressed by the Exposure Draft in a public meeting in August 2002. This Interpretation reflects the results of those deliberations.

Relevant Literature

A6. Paragraph 12 of Statement 5 states the following:

> Certain loss contingencies are presently being disclosed in financial statements even though the possibility of loss may be remote. The common characteristic of those contingencies is a guarantee, normally with a right to proceed against an outside party in the event that the guarantor is called upon to satisfy the guarantee. Examples include (a) guarantees of indebtedness of others, (b) obligations of commercial banks under "standby letters of credit," and (c) guarantees to repurchase receivables (or, in some cases, to repurchase the related property) that have been sold or otherwise assigned. The Board concludes that disclosure of those loss contingencies, and others that in substance have the same characteristic, shall be continued. The disclosure shall include the nature and amount of the guarantee. Consideration should be given to disclosing, if estimable, the value of any recovery that could be expected to result, such as from the guarantor's right to proceed against an outside party.

Basis for Conclusions

Scope of the Interpretation

A7. The Board decided to establish the scope of this Interpretation by identifying the characteristics of the contracts that are subject to its provisions. The Board decided that, except as provided in paragraphs 6 and 7 and discussed in paragraphs A19–A29, guarantee contracts that have any of the following characteristics are included in its scope:

a. Contracts that contingently require the guarantor to make payments to the guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.
b. Contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an agreement (performance guarantees). Thus, the provisions apply to 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 nonfinancial contractual obligation. (A standby letter of credit guaranteeing the performance of a financial contractual obligation is viewed as a financial

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standby letter of credit, which is discussed under (a) above.)

c. Indemnification agreements (contracts) that contingently require the indemnifying party (guarantor) to make payments to the indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, liability, or equity security of the guaranteed party, such as an adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law.
d. Indirect guarantees of the indebtedness of others, as that phrase is used in paragraphs 17 and 18, even though the payment to the guaranteed party is not based on changes in an underlying that is related to an asset or liability of the guaranteed party.

A8. Because this pronouncement is, in part, an Interpretation of paragraphs 8–12 of Statement 5, the Board decided that the scope should, at a minimum, include the examples cited in paragraph 12, such as guarantees of the indebtedness of others. The Board noted that, from the guarantor's perspective, there is little difference in the outcome whether a guarantor is guaranteeing a debtor's repayment of a loan or the market value of the debtor's assets that will be liquidated to repay that loan. Consequently, in paragraph 3(a), the Board established the scope to include guarantees for which the payments are based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party. For guarantees of debt, the Board decided that it should not matter whether the guaranteed party is the creditor or the debtor, that is, whether the guarantor is required to pay the creditor or the debtor (who would then have the funds to pay its debt to the creditor). The underlying (that is, the debtor's failure to make scheduled payments or the occurrence of other events of default) could be related to either the creditor's receivable or the debtor's liability.

a. Paragraph 3(a) in the Exposure Draft referred to payments based on changes in an underlying that is related to only an asset or liability of the guaranteed party. That phrasing inadvertently excluded a guarantee of the market price of the common stock of the guaranteed party, which the Board had intended to include in the scope. Paragraph 3(a) has been revised to also include guarantees with payments based on changes in an underlying that is related to an equity security of the guaranteed party.
b. Some respondents to the Exposure Draft questioned whether characteristic (a) in paragraph 3 would be met for a put option written by a guarantor that did not know whether the guaranteed party had an asset or liability related to the underlying described in paragraph 3(a). The Board noted that if, upon exercise, the put option requires gross settlement (as discussed in paragraph A18) and the asset to be delivered under gross settlement is related to the underlying described in paragraph 3(a), characteristic (a) in paragraph 3 should be considered to be met. In contrast, if the put option permits or requires net settlement, the guarantor must consider its business relationship with the guaranteed party and the other circumstances involved in the issuance of the put option in deciding whether it is probable (as that term is used in Statement 5) that the guaranteed party has, on or about the date of the put option's issuance, an asset or liability related to the underlying described in paragraph 3(a). If the guarantor has no basis for concluding that it is probable that the guaranteed party has that asset or liability, characteristic (a) in paragraph 3 would not be met for that

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written put option. For a put option that permits or requires net settlement and for which characteristic (a) in paragraph 3 is considered to be met at inception, the guarantor should continue complying with the disclosure requirements of this Interpretation over the term of the put option without an ongoing assessment of whether the guaranteed party continues to have the related asset or liability over that period.

A9. Characteristic (a) in paragraph 3 encompasses a financial standby letter of credit, which is an irrevocable undertaking to guarantee payment of a specified financial obligation. But characteristic (a) does not encompass commercial letters of credit [5] and other loan commitments because those instruments do not guarantee payment of a money obligation and do not provide for payment in the event of default by the account party.

a. The Board focused on the substantive differences between (1) financial standby letters of credit and (2) commercial letters of credit and other loan commitments in deciding to structure characteristic (a) to include the former and exclude the latter. The Board noted that, for financial standby letters of credit, amounts are drawn down (that is, payments are made by the issuing institution) only when the account party's financial condition has deteriorated.
b. Furthermore, financial standby letters of credit do not have material adverse change (MAC) clauses or similar provisions that enable the issuing institution (the guarantor) to avoid making a payment. In contrast, many loan commitments contain MAC clauses or other similar provisions that enable the issuing institution to avoid making a loan if the borrower encounters financial difficulties after the loan commitment is issued. Although the Board believes that the disclosures required in this Interpretation would be useful to users with respect to other (non-standby) letters of credit and loan commitments, the Board believes the scope of this Interpretation should include only guarantees because *guarantee* is the common characteristic mentioned in paragraph 12 of Statement 5.

A10. The provisions apply to a guarantee of the market value of an asset held by the guaranteed party. However, a "guarantee" provision in a financial instrument that is commonly thought of as a market value guarantee of the other terms of that same financial instrument does not meet characteristic (a) in paragraph 3 unless that guarantee provision is accounted for separately as a derivative under Statement 133. For example, the put option that is embedded in a puttable bond (but is not accounted for separately as a derivative) could be viewed by the investor (the guaranteed party) as a guarantee against the market value of the remaining instrument (a bond absent the put option) declining below the put price; however, the embedded put option does not meet characteristic (a) because the guaranteed party's asset is an investment in the entire contract, a puttable bond, and not an investment in a nonputtable bond. In contrast, if an investor entered into two separate contracts (a nonputtable bond and a freestanding put option contract that can be settled only by delivery of the bond) and was accounting for them separately, that freestanding put option contract would be a guarantee that meets characteristic (a).

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A11. The Exposure Draft defined an underlying as follows: "An underlying is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or any other variable, *including the occurrence or nonoccurrence of a specified event (such as a scheduled payment under a contract)*" (emphasis added). That definition is the same as the first sentence of the definition of that term in Statement 133, except for the addition of the italicized phrases (which were added to clarify the definition's application to a guarantee contract).

a. Respondents offered diverse comments related to the clarification of the term *underlying*. One respondent asserted that the clarification created a broader definition of *underlying* than exists in Statement 133 by including the words *the occurrence or nonoccurrence of a specified event*. Other respondents stated that the use of the term raised a question about whether the Board was intending to amend the definition of *underlying* in Statement 133. Another respondent requested that the Board state that the occurrence or nonoccurrence of an event is an underlying under Statement 133.
b. The Board decided that the term *underlying* should be used in paragraph 3(a) and that footnote 2 of the Interpretation should quote the definition of *underlying* in Statement 133 as being applicable. The Board also decided to specifically comment that the occurrence or nonoccurrence of a specified event (such as a scheduled payment under a contract) is a variable that is considered an underlying under that definition. The Board rejected a suggestion that the comment clarifying the definition not be used in the Interpretation until the Board adds that clarification to Statement 133 in finalizing its project to amend that Statement. The Board concluded that the additional comment was important in helping constituents understand the scope of the guarantees addressed in the Interpretation.

A12. A respondent indicated that paragraph 3(a) appears to include in the scope of the Interpretation each contract that meets the definition of a derivative instrument in Statement 133, whether or not that contract is subject to the reporting requirements of Statement 133, including, for example, regular-way securities trades, normal purchases and normal sales, and weather derivatives. The Board disagreed with that respondent.

a. Regular-way securities trades and derivatives that qualify for the normal purchases and normal sales exception are forward contracts that meet one of the net settlement characteristics in paragraph 6(c) and related paragraph 9 of Statement 133. The net settlement of noncontingent forward contracts could involve a net settlement payment from either party. Therefore, those contracts are not included in the scope of this Interpretation. In contrast, option-based contracts in which any net potential contingent payment can flow only from the guarantor to the guaranteed party may meet one of the characteristics in paragraph 3 and be included in the scope of this Interpretation. (Some guarantees obligate the guaranteed party to pay all or a portion of the premium to the guarantor at a later date; those premium payments are not contingent payments as discussed in the previous sentence.) Contingent forward contracts may also meet one of the characteristics in paragraph 3 and be included in the scope of this Interpretation. (A freestanding put option contract that can be settled only by delivery of the asset related to the underlying could be

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viewed as a contingent forward contract.)

b. Weather derivatives typically are option-based contracts that involve a payment to the guaranteed party based on a climatic or geological variable, such as the occurrence or nonoccurrence of a specified amount of snow at a specified location within a specified period of time. However, the characteristic in paragraph 3(a) involves payments based on changes in an underlying that is related only to an asset or liability of the guaranteed party. Since the climatic or geological variable is not an asset or liability of the guaranteed party, the weather derivative is not a guarantee under paragraph 3(a).

A13. The Board noted that one of the examples cited in paragraph 12 of Statement 5 is standby letters of credit, which include both financial standby letters of credit and performance standby letters of credit. The former are included in characteristic (a) in paragraph 3. Characteristic (b) of paragraph 3 was necessary to include the latter in the scope of this Interpretation.

a. Other contracts that are similar to performance standby letters of credit (such as bid bonds and performance bonds) are included in the scope of this Interpretation.
b. An entity's guarantee of its own future performance, such as that entity's completion of a contract by a specified deadline, is not encompassed by characteristic (b) nor by any other characteristic in paragraph 3. Some respondents indicated that they viewed a take-or-pay contract as a guarantee by the buyer to pay for the portion of the minimum quantity of product or output of the guaranteed party for which the buyer refuses to order or accept delivery. Take-or-pay contracts are not included in the scope of this Interpretation because the minimum payments under the take-or-pay contract are not contingent; the take-or-pay contract requires certain minimum payments irrespective of whether the buyer accepts delivery. However, even if a take-or-pay contract were analyzed as though it were a guarantee, it would not be included in the scope of this Interpretation because it would be a guarantee related to the buyer's future performance under the contract.

A14. Indemnification agreements function like guarantees. The Board decided to present characteristic (c) separately in paragraph 3 to make clear that indemnification agreements are included in the scope of this Interpretation.

A15. The Exposure Draft specified characteristic (c) as follows: "Indemnification agreements (contracts) that contingently require the indemnifying party (guarantor) to make payments to the indemnified party (guaranteed party) based on the occurrence of a specified event, such as an adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law."

a. A number of respondents expressed concern that the phrasing of this characteristic was too broad and requested clarification regarding what types of instruments (indemnifications) the Board intended to include in the Interpretation. Some respondents requested a scope exception for indemnifications arising under normal purchases and sales similar to the exception included in Statement 133. Others requested that *all* indemnifications be

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excluded from the scope of this Interpretation.

b. The Board had intended the characteristic used to identify indemnification agreements in the Exposure Draft to be limited so that only indemnifications that function like the guarantees described in paragraph 3(a) would be included in the scope. The Board agreed with respondents that the scope of the Exposure Draft with respect to indemnification agreements was written too broadly and modified characteristic (c) accordingly.

A16. Some respondents also expressed concern over whether specific types of indemnifications would be included in the scope of the Interpretation. For example, a number of respondents questioned whether a lessee's indemnification of a lessor for any adverse tax consequences that may arise from the lessee's own misuse of the leased property under a tax indemnification agreement would be considered a guarantee subject to the accounting and disclosure requirements of this Interpretation.

a. The Board emphasized that any guarantee of an entity's own future performance is not a guarantee within the scope of this Interpretation. For example, a lessee will often indemnify a lessor for any adverse tax consequences that may arise from acts, omissions, and misrepresentations of the lessee (for example, using the leased asset outside the United States or subleasing to a tax-exempt entity). The lessee is, in effect, guaranteeing that its own future performance and actions with respect to the lease and the leased property will not result in adverse tax consequences to the lessor. Thus, that lessee's indemnification is not within the scope of the Interpretation.

b. A guarantee of a guarantor-lessee's own future performance under the tax indemnification described in (a) above differs from a lessee's indemnification of the lessor for any adverse tax consequences that may arise from a change in the tax laws. Only a legislative body can change the tax laws, and the lessee therefore has no control over whether payments will be required under that indemnification. A guarantee by the lessee regarding the effect of future changes in the tax law on the guaranteed party's tax liability is, therefore, within the scope of this Interpretation. Similarly, a seller's indemnification against additional income taxes due for years prior to a business combination relates to the seller-guarantor's past performance, not its future performance, and would be within the scope of this Interpretation.

A17. Because the Board concluded in Interpretation 34 that the term *guarantees of indebtedness of others* in paragraph 12 of Statement 5 includes indirect guarantees of indebtedness of others, the Board decided that those indirect guarantees should also be included in the scope of this Interpretation under paragraph 3(d). However, a written option that does not directly guarantee another entity's performance or the value of the guaranteed party's assets (such as a weather derivative) is not included in the scope of this Interpretation unless that written option is used as an indirect guarantee of the indebtedness of others.

A18. The Board believes that the payments by the guarantor (referred to in paragraph 3) could be in cash, financial instruments, other assets, shares of its stock, or provision of services. Those

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payments could involve a gross settlement, in which certain assets are concurrently transferred to the guarantor in exchange for the specified consideration (as in the settlement of an exercised put option or other contingent forward contract), or a net settlement. Both financial and nonfinancial contracts are included in the scope of this Interpretation. However, guarantees that involve payments denominated in shares of the guarantor's stock possibly may not be subject to the initial recognition and initial measurement provisions of this Interpretation under the limited scope exception in paragraph 7(d).

Scope Exceptions

A19. The Board decided to exclude certain guarantee contracts from the scope of this Interpretation. Those contracts and the reasons for excluding them follow.

a. A guarantee or an indemnification that is excluded from the scope of Statement 5 under paragraph 7 of that Statement. The scope of this Interpretation should not be broader than the Statement it interprets. Thus, those items not within the scope of Statement 5 are also not within the scope of this Interpretation. That paragraph (as amended) indicated that the accounting for pension costs, for vacation pay, and for deferred compensation contracts and stock issued to employees are excluded from the scope of Statement 5. The accounting for other employment-related costs is also excluded except for postemployment benefits that become subject to the provisions of Statement 5 through application of FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits.*
b. A lessee's guarantee of the residual value of the leased property at the expiration of the lease term if the lessee (guarantor) accounts for the lease as a capital lease. Because the accounting for a capital lease under Statement 13 includes the amount of the lessee's residual value guarantee in the calculation of the lessee's recognized liability for its obligations under the capital lease, the Board concluded that the scope exception is necessary if the lessee accounts for the lease as a capital lease. The Board also considered but rejected a scope exception for a lessee's residual value guarantee if the lessee accounts for the lease as an operating lease because under the accounting for an operating lease, a liability for the guarantee is not recognized.
c. A guarantee contract or an indemnification agreement that is issued by either an insurance company or a reinsurance company and accounted for under Statement 60, 97, 113, or 120.
    (1) The Exposure Draft did not refer to Statement 120 in detailing the list of specialized insurance accounting principles. The Exposure Draft also did not discuss the applicability of the scope exclusion to specific types of guarantees embedded in investment and insurance contracts. One respondent recommended that the scope exclusion extend to guarantees and indemnifications accounted for under Statement 120, and the interpretive guidance issued for Statements 60, 97, 113, and 120. Another respondent questioned whether the scope exclusion applies to annuitization guarantees and investment contracts, as defined in Statement 97, issued by insurance enterprises.
    (2) The Board agreed with respondents that clarification of the scope exception in the Exposure Draft was necessary. The Board excluded the insurance and investment

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contracts accounted for under Statements 60, 97, 113, and 120 from the Interpretation's scope to avoid creating a conflict with the accounting principles in those Statements.

d. A contract that meets the characteristics in paragraph 3(a) but is accounted for as contingent rent under Statement 13, as amended. The Board wanted to avoid creating a conflict with the accounting principles in that Statement.
e. A contract that meets the characteristics in paragraph 3(a) but provides for payments that constitute a vendor rebate (by the guarantor) based on either the sales revenues of or the number of units sold by the guaranteed party. The Board believes that the issue of vendor rebates should not be addressed in this Interpretation. The Board plans to address that issue in its project on revenue recognition.
f. A guarantee (or an indemnification) whose existence prevents the guarantor from being able to either account for the transaction as the sale of an asset that is related to the guarantee's underlying or recognize in earnings the profit from that sale transaction. An example of such a guarantee is discussed in paragraphs 25 and 28 of FASB Statement No. 66, *Accounting for Sales of Real Estate.* Where the guarantee serves as an impediment to sales accounting or recognizing the profit from a sale, the guarantor and guaranteed party will both have the asset on their books. Thus, the guarantee would otherwise be within the scope of this Interpretation under characteristic 3(a). However, the Board believes that other GAAP literature adequately addresses the accounting for those situations and does not want this Interpretation to conflict with that guidance.

A20. The Board also decided to exclude the following guarantee contracts from the initial recognition and initial measurement provisions of this Interpretation (but not from its disclosure requirements) because existing standards prescribe those recognition and measurement requirements:

a. A guarantee that is accounted for as a derivative instrument at fair value under Statement 133 as amended.
    (1) Some respondents raised concerns about applying the disclosure requirements specified in this Interpretation to derivatives accounted for under Statement 133. Respondents argued that the derivative instruments are already subject to considerable disclosure requirements under Statement 133, and they thought the disclosures required by this Interpretation would not provide further useful information. Respondents also argued that the disclosures under the Interpretation would confuse users when read in conjunction with related disclosures under Statements 107 and 133.
    (2) The Board rejected those suggestions and noted that the issuance of Statement 133 did not change the applicability of Statement 5. Guarantees accounted for as derivatives under Statement 133 have remained subject to the disclosure provisions in paragraphs 9–12 of Statement 5 because Statement 133 did not amend Statement 5. The Board believes that the disclosures specified in this Interpretation will provide users of financial statements with more detailed and useful information about guarantees that are accounted for as derivatives.
b. Provisions in a business combination to pay contingent consideration (as addressed in

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Statement 141).

c. A guarantee by an original lessee that has become secondarily liable under a new lease that had relieved the original lessee from being the primary obligor (that is, the principal debtor) for the lease payments under the original lease, as discussed in paragraph 38 of Statement 13, as amended by Statement 145. The Board observed that this exception shall not be applied by analogy to secondary obligations that are not accounted for under the lease accounting provisions in paragraph 38 of Statement 13.

A21. The Board also excluded from the initial recognition and measurement provisions product warranties and other guarantee contracts for which the underlying is related to the functional performance of nonfinancial assets that are owned by the guaranteed party—that is, the underlying is related to whether or how well the nonfinancial asset functions or operates and not to changes in its value or price. This scope exception was partially based on the existence of applicable recognition and measurement guidance for separately priced extended warranty or product maintenance contracts in Technical Bulletin 90-1 and partially based on practical reasons. Some respondents questioned, for example, whether a representation by a manufacturer to its customer that a particular engine would produce a specified savings in its energy consumption qualifies for this scope exception. The Board noted that such a representation would qualify for that scope exception because it relates to how efficiently the engine operates. In contrast, a service provider's representation as to the quality of its services does not need to qualify for that scope exception because it is a guarantee of the service provider's (guarantor's) future performance and, as such, is not included in the scope of this Interpretation under paragraph 3.

Guarantees Issued either between Parents and Their Subsidiaries or among Corporations under Common Control

A22. A number of respondents raised questions about guarantees issued either between parents and their subsidiaries or among corporations under common control or related to guarantees involving related parties.

A23. Some respondents asked what the effect would be in consolidation if a liability were recognized at inception for a parent's guarantee of a subsidiary's debt to a third party or for guarantees issued between parents and their subsidiaries. The Board noted that guarantees issued between parents and their subsidiaries are intercompany transactions that are eliminated in consolidation and, thus, those guarantees are not subject to the requirements of this Interpretation for purposes of consolidated financial reporting. In contrast, a parent's guarantee of a consolidated subsidiary's debt to a third party does not involve an intercompany transaction. But because the consolidated financial statements would report the consolidated subsidiary's debt to a third party as a liability of the consolidated entity, the parent's guarantee of a subsidiary's debt to a third party would simply be a guarantee of the consolidated entity's own performance to make the scheduled payments on that consolidated liability, which is not a guarantee subject to the recognition, measurement, and disclosure provisions of the Interpretation. (Similarly, if a debtor agrees to pay a late fee if it fails to make a scheduled

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installment payment on its loan from the bank, that agreement is a guarantee of the debtor's own performance, which is not subject to the Interpretation.)

A24. Some respondents requested a scope exception for guarantees issued between parents and their subsidiaries (essentially only for purposes of the subsidiary's or parent's separate financial statements), among corporations under common control, and to creditors of those related parties, and questioned the value of disclosing those types of guarantees. In addition, some respondents argued that it would be nearly impossible to value the guarantee of a related party's debt to a third party as it would not be an arm's-length transaction. Those latter respondents requested scope exceptions from the entire Interpretation, although the measurement difficulties they described arise from the recognition and initial measurement provisions. The Board agreed that special difficulties exist in determining the fair value of guarantees in the above situations and decided to exclude from the initial recognition and initial measurement provisions the following guarantees (if not already excluded from the scope of this Interpretation as discussed in paragraph A23):

a. Guarantees issued between either parents and their subsidiaries or corporations under common control
b. A guarantee of a subsidiary's debt to a third party by a parent (whether the parent is a corporation or an individual)
c. A subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent. (Corporations under common control would be viewed in this situation as subsidiaries of a parent who is an individual or a group of individuals.)

The Board noted that no arm's-length transaction exists when any of these parent-subsidiary (or common control) guarantees are made, as the parent controls the resources that affect whether the triggering event occurs, which would require the guarantor (either the parent or subsidiary) to perform under a guarantee. The Board also noted that if separate-company financial statements were presented, users would also receive important information about those guarantees because the disclosures are still required for guarantees that are subject to this Interpretation.

Liabilities versus Equity Instruments

A25. The Board believes that the scope of the initial recognition and measurement requirements of this Interpretation should include only guarantees in which the obligation is a liability consistent with the elements definition in the conceptual framework. Therefore, if the guarantee contract stipulates that the guarantor's payment, if required, can be in the form of the guarantor's own equity shares at the guarantor's option, that obligation may, depending on the arrangements of the contract, be considered to be equity rather than a liability and, if so, the guarantee contract is not subject to the initial recognition and measurement requirements of this Interpretation. The Board believes the disclosure requirements are relevant and applicable in that circumstance. Under the Board's recent tentative decisions in its project on distinguishing between liability and equity instruments, a guarantee represents a liability (not an equity instrument) if the guarantor's

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payment is a variable number of shares representing a fixed monetary value. Consequently, resolution of that project could affect the application of the above scope exception for the initial recognition and initial measurement requirements of this Interpretation.

Applicability of the Statement 5 Requirements to Share-Trust Arrangements

A26. Under some arrangements, a loss under a guarantee is settled by the guarantor's issuing a variable number of its own equity shares. Those arrangements are often called share-trust or share-collateral transactions, whereby some specified number of the guarantor's shares is put in a trust or in some other similar arrangement to facilitate performance under the guarantee. The Board decided that the use of collateral arrangements under that guarantee does not change the accounting under Statement 5 nor does it eliminate the recognition, measurement, and disclosure requirements under that Statement and this Interpretation. Furthermore, the Board observed that those arrangements also could affect the calculation of earnings per share under FASB Statement No. 128, *Earnings per Share,* and disclosures thereunder.

Nonpublic Companies

A27. Several respondents requested that a scope exception be made for certain nonpublic companies. The scope exceptions sought by respondents ranged from excluding all nonpublic companies, not-for-profit entities, and issuers of personal financial statements to excluding only those nonpublic companies that Statement 126 exempts from the disclosure requirements of Statement 107. Many respondents indicated that they were requesting a scope exception only if the Board decided not to remove the recognition and measurement provisions in the Exposure Draft. The reasons for a scope exception for nonpublic companies varied.

A28. Some respondents argued that the issuance of guarantees is common in private companies, and those companies would have to bear a disproportionate implementation burden. In addition, many respondents argued that most small- and medium-sized businesses would not be able to make the calculations necessary to measure a guarantee's fair value at a reasonable cost, nor would the guarantee liability provide useful information to the creditors of such businesses. Other respondents noted that for nonpublic companies, guarantees are most often associated with debts of affiliates for which lenders obtain the financial statements of the affiliated entities. They reasoned that because the lenders are knowledgeable as to the activities, financial condition, and relationship of these affiliates, additional disclosures of the guarantees were unnecessary.

A29. The Board believes that if the respondents' assertions that guarantees issued by nonpublic entities are typically between parents and subsidiaries or companies under common control are true, the scope exception from initial recognition and initial measurement for parent-subsidiary guarantees and other types of guarantees involving certain related parties will significantly reduce the number of guarantees that nonpublic entities will have to measure at fair value and, thus, will alleviate nonpublic entities' concerns about the cost of complying with this Interpretation. The Board decided that a broad scope exception is not warranted; if a nonpublic

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company chooses to issue a guarantee, the initial recognition, initial measurement, and disclosure provisions of this Interpretation will provide useful information to the users of that nonpublic company's financial statements. The Board, therefore, rejected respondents' requests for a broad scope exception for all nonpublic companies.

Initial Recognition and Initial Measurement of the Liability for a Guarantor's Obligation

A30. The Board believes that the issuance of a guarantee obligates the guarantor in two respects: (a) the guarantor undertakes a noncontingent obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur and (b) the guarantor undertakes a contingent obligation to make a future sacrifice—to make future payments—if those triggering events or conditions occur. The Board believes that entering into a contract or agreement that imposes on the guarantor an ongoing obligation to stand ready to perform over the term of the guarantee warrants immediate recognition of a liability for the obligations under the guarantee, even if it is *not* probable that the specified triggering events or conditions (that would cause payments under the guarantor's related contingent obligation) will occur.

A31. If a guarantor wants to be relieved of both its obligation to stand ready to perform over the remaining term and its contingent obligation to make future payments (before the triggering events or conditions have occurred and before the term of the guarantee has ended), the guarantor would likely be required to make a payment either to a third party to assume its obligations or to the original guaranteed party. The Board believes that the need for the guarantor to make a future payment to be relieved of its obligations under the guarantee confirms the existence of the liability related to the guarantor's obligations under the guarantee.

A32. Some have suggested that if the guarantor does not receive a separately identified premium when it issues a guarantee, no liability should be recognized at the inception of the guarantee. For example, in conjunction with the cash sale of equipment to a customer, a manufacturer may issue to its customer's bank a guarantee of the customer's loan for which the proceeds are used to pay for the equipment. [6] There is no separately identified premium for the guarantee, although the sales arrangement may impound an implicit premium. The manufacturer may simply view the guarantee as an accommodation to its customer. Although the recognition requirements in Statement 5 pertaining only to loss contingencies have not been met at the inception of the guarantee, the Board believes that the seller-guarantor has incurred an obligation identical to the obligation it would incur if it required its customer to pay an explicit premium for the guarantee. Thus, the seller-guarantor should immediately recognize a liability for its obligations under a newly issued guarantee, even if a separately identified premium was not received. If an entity guaranteed a customer's bank loan purely as an accommodation to an important longstanding customer, unrelated to a specific transaction, the Board believes the liability for the entity's obligations under the guarantee should be recognized. That view about the absence of a stated premium is consistent with the guidance in paragraph 114 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and*

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Extinguishments of Liabilities, which discusses the accounting for the extinguishment of liabilities when a creditor legally releases a debtor from the primary obligation (that is, from being the principal debtor) on the condition that a third party assumes the primary obligation and that the original debtor becomes secondarily liable. Paragraph 114 states that ". . . whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor. . . ."

A33. A significant majority of respondents opposed the recognition requirements of this Interpretation. Their reasons focused on (a) whether the obligation under the guarantee meets the current definition of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements,* when it is not probable that the guarantor will be required to make a payment under the guarantee and (b) whether the liability recognition requirement is consistent with Statement 5.

A34. Respondents who opposed initial recognition of a liability commonly quoted the definition of a liability presented in Concepts Statement 6 and argued that the liability required by the Interpretation does not represent a probable future sacrifice of economic benefits. They argued that there is no probable future sacrifice by the guarantor at inception of the guarantee and, thus, no liability according to Concepts Statement 6. Many respondents asserted that a guarantee does not represent a liability of an entity until the triggering event is probable of occurring. Those respondents focused on the term *probable* in Concepts Statement 6, contending that even if a guarantor is obligated to stand ready, it is not probable (as defined in Statement 5) that it will incur a future economic sacrifice as a result of standing ready. Some respondents asserted that the creation of the guarantee is proof that a future sacrifice is improbable because a guarantor would not enter into a transaction where a future payment is likely. A number of respondents also argued that there is no present obligation at inception of the guarantee, but rather an agreement by the guarantor to perform in case an obligation arises as a result of the occurrence of a triggering event.

A35. The Board rejected the arguments that the guarantor's obligations under the guarantee, which encompass its obligation to stand ready to perform, do not meet the definition of a liability. The Board noted that while respondents focused their arguments on paragraph 35 and the first half of paragraph 36 of Concepts Statement 6, they neglected to mention the passage found later in paragraph 36 that states, ". . . liabilities may not require an entity to pay cash but to convey other assets, to provide or *stand ready* to provide services, or to use assets" (emphasis added). Their arguments also neglected to acknowledge that *probable* is used to convey different meanings in Statement 5 and Concepts Statement 6, as discussed in footnote 21 to paragraph 35. The Board noted that Concepts Statement 6 explicitly states in paragraph 196 that a guarantee meets the definition of a liability: "Responsibilities such as those to . . . honor warranties and guarantees also create liabilities under the definition." Thus, the Board believes that the requirement to recognize a liability for the guarantor's obligation when it is not probable that the guarantor will be required to make a payment under the guarantee is consistent with the

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definition of a liability under Concepts Statement 6.

A36. Respondents also commonly argued that the requirement to record a liability for the guarantor's obligation is not a legitimate interpretation of Statement 5 but rather a change in GAAP. Similar to the arguments concerning Concepts Statement 6, respondents stated that the requirement to recognize a liability for an event that is unlikely to occur (performance under the guarantee) is a significant change in accounting from that required by Statement 5. Respondents argued that a liability should be recognized only when the loss under the guarantee is both probable and reasonably estimable, in accordance with Statement 5. Other respondents stated that an Interpretation could not address recognizing a liability for a noncontingent obligation to stand ready and still be an interpretation of Statement 5 because Statement 5 addresses only loss contingencies. They argued that any requirement for recognition of a liability amounted to a change in GAAP and could come only through the issuance of a Statement of Financial Accounting Standards.

A37. The Board disagrees with the argument of constituents that the provisions of Statement 5 prohibit the recognition of a liability for a guarantee if it is not probable that payments will be required under the guarantee. The probability of performance under the guarantee will affect the measurement of the liability at inception, but the probability of performance does not change the fact that a liability has been created upon the issuance of the guarantee and should therefore be reflected in the financial statements. Under the respondents' argument, any premium received for a guarantee for which it was not probable that a payment would be required would be immediately recognized in earnings, contrary to the economics of the arrangement and to current practice by guarantors that receive specifically identified premiums. The Board believes that the recognition of a liability for a guarantee is a valid Interpretation of Statement 5 because the Interpretation clarifies that Statement 5 should not be understood as prohibiting the recognition of a liability for the obligations undertaken in issuing a guarantee, even if the likelihood of the event that would trigger performance under the guarantee is less than probable.

Initial Measurement

A38. The Board decided to provide guidance on the initial measurement of a guarantor's liability at the inception of the guarantee. In many cases, the one-time premium received by the guarantor for issuing a guarantee will be an appropriate initial measurement. However, if a one-time premium is specified for a guarantee that is issued in conjunction with another transaction (such as the sale of assets by the guarantor), the specified premium may not be an appropriate initial measurement of the guarantor's liability because the amount specified as being applicable to the guarantee may or may not be its fair value. The Board believes that the objective of the initial measurement of the guarantor's obligations under the guarantee contract should be fair value.

A39. If, at the inception of the guarantee, no liability is recognized under Statement 5 for the contingent loss related to the guarantee, the liability to be initially recognized for the guarantor's

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obligations under the guarantee should be the fair value of the guarantee. In the unusual circumstance that, at the inception of the guarantee, a liability is recognized under Statement 5 for the related contingent loss, the liability to be initially recognized for the guarantor's obligation under the guarantee should be the greater of (a) the amount that satisfies the fair value objective as discussed in paragraph 9 or (b) the contingent liability amount required to be recognized at inception of the guarantee by Statement 5.

A40. A large majority of respondents opposed the Exposure Draft's requirement that the initial measurement of the liability be its fair value. Respondents, most of whom supported the enhanced disclosures contemplated herein, said the cost of determining the fair value of a guarantee would exceed any incremental benefit from its recognition. They observed that the measurements would be costly to perform and that the Interpretation did not elaborate on how to measure a guarantee liability at fair value. Respondents frequently argued that they would not be able to reliably measure a liability at fair value because the Interpretation did not discuss how to perform that measurement. Those respondents explained that companies would be forced to estimate the fair value of their guarantees using different assumptions and valuation techniques, resulting in a lack of comparability among companies, because most guarantees are not traded in a secondary market. They added that a fair value measurement would lead to diversity in practice, which is counter to the Interpretation's stated objective of reducing diversity in practice.

A41. The Board believes the fair value measurement will enhance, rather than diminish, the comparability of financial statements. The Board notes that Concepts Statement 7 provides a tool, expected present value, to assist in measurement of the fair value of guarantees. The fair value of each guarantee will necessarily be based on the facts and circumstances surrounding the agreement. The techniques used to value one particular guarantee may not be appropriate to value another guarantee. Undoubtedly, a preparer of financial statements will need to make an estimate of a guarantee's fair value, where no established market exists, based on a set of assumptions. But the need to make estimates does not, in the Board's view, undermine the integrity of the fair value measurement. Paragraph 73 of Concepts Statement 7 states, "Techniques like the use of expected cash flows can extend the application of present value to measurements for which it was previously considered unsuitable. The use of simplifying assumptions allows accountants to develop present value measurements that are sufficiently reliable and certainly more relevant than undiscounted measurements." Requiring an initial measurement at inception of the guarantee for which the objective is fair value will result in a more accurate depiction of the economic substance of the transaction than is currently being provided in financial statements.

A42. The Board believes that the initial measurement requirement will not unduly burden guarantors and their auditors. The Board noted that this Interpretation requires a fair value measurement only at inception of the guarantee. Furthermore, the prospective application to only those guarantees issued or modified after December 31, 2002, will alleviate the burden of initially adopting this Interpretation.

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A43. The Board also believes that the required initial measurement of the guarantor's obligation, in conjunction with the disclosures required by the Interpretation, will provide users with more insight into a company's guarantee transactions than currently exists. Companies will be required to include in their financial statements a liability that, in current practice, is often left off the balance sheet when the issuance of the guarantee is combined with another transaction.

A44. Respondents also asserted that the requirement to measure the initial liability for the guarantor's obligation at fair value could not be considered an interpretation of Statement 5 because Statement 5 does not require a fair value measurement. The Board disagreed with the respondents and noted that several Interpretations provide guidance in areas where the Statements they interpret were silent.

A45. Several respondents asserted that the requirement for the guarantor to recognize a liability for the fair value of the guarantee would result in the double counting of debt, once by the guaranteed party and again by the guarantor. Those respondents apparently confused the fair value of the guarantee with the maximum total amount that could potentially be paid under a guarantee. A guarantee of another entity's debt is a liability separate from the debt. The guarantor's recognition of the guarantee's fair value at inception would not be equal to the amount borrowed; thus, the debt would not be double counted. Other respondents stated they did not know how to bifurcate and value the contingent and noncontingent aspects of the guarantor's obligation. No bifurcation of the contingent and noncontingent aspects of the guarantee is required under this Interpretation. This Interpretation describes those two aspects of the guarantor's obligation only to emphasize that the guidance in Statement 5 regarding loss contingencies does not control or prohibit the recognition of a liability arising from the issuance of a guarantee.

A46. The Board considered which measurement attribute is appropriate for initially recognizing the guarantor's obligation under a guarantee. The Board noted that paragraph 11 of Statement 140 discusses the initial measurement of a guarantee received or written in conjunction with a transfer of assets accounted for as a sale. Paragraph 11 states that the transferor (seller) shall "initially measure at fair value assets obtained and liabilities incurred in a sale"; similarly, it states that the transferee "shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value. . . ." The Board also noted that the issuance of a guarantee is an exchange transaction and fair value is the attribute commonly used in initially recognizing most exchange transactions. The Board believes there is no basis for deviating from that practice. Moreover, the fair value of many guarantees will be measured using estimated cash flows. Concepts Statement 7 states that when using present value of estimated cash flows, the objective of initial (and fresh start) measurements is fair value. The Board concluded that fair value is the appropriate measurement objective to be used in initially recognizing the guarantor's liability under this Interpretation.

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A47. The Board also emphasized that the fair value of a guarantee at inception is not equal to the guarantor's single best estimate of what it will be required to pay under the guarantee. The notion of fair value contemplates the range of probabilities and potential payments that could be required under the guarantee, not merely a point estimate of the most likely outcome.

The Guarantor's Offsetting Entry

A48. Some respondents requested that the Interpretation provide guidance about the guarantor's offsetting entry when it initially recognizes a liability for the guarantor's obligations. This Interpretation does not prescribe a specific account for the guarantor's offsetting entry in initially recognizing the liability for the guarantor's obligations under the guarantee, because (a) that topic is beyond the scope of this Interpretation and (b) the offsetting entry will depend on the circumstances in which the guarantee is issued. Although the Board affirmed that detailed requirements should not be provided in this Interpretation, it decided to provide several examples of such possible situations.

Subsequent Measurement

A49. The Exposure Draft did not provide guidance for the subsequent accounting (including measurement over the remaining term of the guarantee) of the guarantor's initial liability because the Board had decided that this subsequent measurement issue was beyond the scope of this Interpretation. Many respondents requested guidance on the subsequent accounting for the liability that the guarantor is required to recognize at inception of the guarantee. The Board affirmed its decision that providing guidance on the subsequent accounting was beyond the scope of this Interpretation. Nevertheless, the Board decided to point out that the guarantor's initial liability recognized under paragraph 9 is typically reduced (by a credit to earnings) in present practice as the guarantor is released from risk under the guarantee. The Board also decided to mention three methods used in practice for subsequent accounting related to release from risk. The Board noted that for those guarantees that are derivatives, which are measured at fair value under Statement 133, the carrying amount of the liability might increase or decrease in a given period after initial measurement.

Disclosures about a Guarantor's Obligations under Guarantees

A50. Paragraph 12 of Statement 5 states that disclosures about guarantees "shall include the nature and amount of the guarantee." It also states that "consideration should be given to disclosing, if estimable, the value of any recovery that could be expected to result, such as from the guarantor's right to proceed against an outside party."

A51. Because guarantees can arise in widely varying commercial transactions and business relationships, [7] and because guarantees can take diverse forms, the Board decided that some elaboration was needed on the meaning of *the nature and amount of the guarantee* in paragraph 12 of Statement 5. The clarification and elaboration are modeled on the required disclosures about concentrations of credit risk originally in FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments*

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with Concentrations of Credit Risk, and now in Statement 107, as amended by paragraph 531 of Statement 133.

A52. The Board decided that a guarantor should disclose the following information (except as noted below) about each guarantee, or each group of similar guarantees, even if the likelihood the guarantor will have to make any payments under the guarantee is remote:

a. The nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose (such as from transactions with joint ventures or franchisees or as compensation to employees), and the triggering events or circumstances that would require the guarantor to perform under the guarantee.
b. The maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee.
c. The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee (including the liability, if any, recognized under paragraph 8 of Statement 5), regardless of whether the guarantee is freestanding or embedded in another contract. In addition, a guarantor that has issued a product warranty also shall disclose its accounting policy and methodology used in determining its liability (including any liability [such as deferred revenue] associated with extended warranties) for that product warranty as well as a tabular reconciliation of the changes in the guarantor's product warranty liability for the reporting period. That reconciliation shall present, among other things, the aggregate settlements made (in cash or in kind) under the product warranty, the aggregate changes in the liability for accruals related to product warranties issued during the reporting period, and the aggregate changes in the liability for accruals related to preexisting warranties (including adjustments related to changes in estimates).
d. The nature of (1) any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee and (2) any assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee. The Board also decided that the guarantor shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the guarantee.

In addition to the above required disclosures, a guarantor may choose to disclose other quantitative information about its obligations under a guarantee.

A53. The Board decided that the disclosure of the maximum amount of future payments should not reflect any reduction for the current carrying amount of the liability for the guarantor's obligations under the guarantee (including the liability recognized under Statement 5) or the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the guarantee. Rather, the Board decided that those amounts should be disclosed separately.

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A54. The Board also decided that the requirement to disclose the maximum amount of future payments does not apply to product warranties.

a. The Exposure Draft required that guarantors disclose the maximum potential amount of future payments for all covered guarantees, including product warranties. Respondents argued for a scope exception from all of the Interpretation's disclosure requirements for product warranties for both conceptual and application reasons.
   (1) Although the scope of this Interpretation excludes a guarantee of the guarantor's future performance, that exclusion does not affect product warranties because conceptually, product warranties are actually guarantees of the company's own past performance, not its future performance. The Board notes that a product warranty relates to an asset of the guaranteed party, which the Board deliberately included in the scope.
   (2) Other respondents expressed concerns about the practicality of the required disclosures for product warranties. Specifically, several respondents suggested that the maximum potential amount of future payments the guarantor could be required to make under a warranty would approximate the total revenues from sales of the products under warranty. In addition, some respondents questioned whether users of financial statements even seek additional disclosures about product warranties.
b. The Board decided to eliminate for product warranties the proposed requirement to disclose the maximum potential amount of future payments the guarantor could be required to make under those warranties. But the Board reaffirmed that, for product warranties, guarantors shall comply with the other disclosure requirements. The Board noted that the maximum potential amount of future payments may not be very meaningful to users since it is based on the assumption that all of a company's products would fail totally. The Board concluded that users of financial statements would likely not receive significant benefit from a disclosure of that maximum amount for product warranties. However, in addition to eliminating the requirement to disclose the maximum potential amount of future payments under product warranties, the Board also decided that certain additional information about product warranties is needed, as discussed in paragraph A55.
c. Several respondents noted that it is not always possible to determine the maximum potential payout under an indemnity. Those respondents requested that an exception be made for disclosure of the maximum potential amount of payment when it is not possible to make such an estimate, with the company providing the reasons why it cannot estimate the maximum amount. The Board agreed with those respondents. The Board believes that the disclosure of the reasons that the maximum potential amount could not be determined will provide users with a better understanding of the guarantor's risks created by the issuance of the guarantee than if no explanation was provided.

A55. With respect to product warranties, the Board noted that users of financial statements have expressed concern that they currently receive only minimal information describing a company's warranty-related obligations. The Board believes that a tabular reconciliation will provide users with valuable information without imposing significant additional costs on preparers, who

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typically have such information readily available. Furthermore, that tabular reconciliation will provide greater transparency of information about the obligations incurred and settlements made under product warranties. The Board considers the requirement to include a tabular reconciliation to be a clarifying elaboration of the proposed provision in the Exposure Draft requiring a guarantor to disclose the carrying amount of the guarantor's liability.

Rescission of Interpretation 34

A56. To facilitate the simplification of accounting standards, the Board decided that the interpretive guidance in Interpretation 34, which also interprets paragraph 12 of Statement 5, should be incorporated into this Interpretation without change. Thus, Interpretation 34 is superseded by this Interpretation.

Effective Date and Transition

A57. Because the guidance in Interpretation 34 was incorporated into this Interpretation without change, the Board decided that paragraphs 17 and 18 of this Interpretation should continue to be required for financial statements for fiscal years ending after June 15, 1981—the effective date of Interpretation 34.

A58. To provide for prompt correction of possible problems arising from diversity in practice, the Board decided that the disclosure, recognition, and measurement provisions of this Interpretation should be applied to financial statements issued soon after the pronouncement's issuance. It decided that the disclosure requirements in paragraphs 13–16 should be effective for financial statements of interim or annual periods ending after December 15, 2002. The Board decided that the initial recognition and initial measurement provisions in paragraphs 9 and 10 should be applied on a prospective basis only to guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The guarantor's previous accounting for guarantees issued prior to the date of the Interpretation's initial application shall not be revised or restated to reflect the effect of the recognition and measurement provisions of the Interpretation. The Exposure Draft had proposed that the initial recognition and measurement provisions be applied to all previously issued guarantees in the first fiscal year beginning after September 15, 2002, with the cumulative effect of initially applying this Interpretation reported as a change in accounting principle in the first interim period of that fiscal year. The Board noted that many constituents expressed concerns over the cost of gathering historical information about guarantees and having to determine the fair value of the guarantee at the time it was issued. The Board decided that applying the initial recognition and initial measurement provisions on a prospective basis would help address those concerns.

A59. The Board also decided to delay the Interpretation's effective date. It believes that the specified effective dates will allow sufficient time to implement the disclosure and accounting provisions, particularly given the existing requirements of other pronouncements.

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Impact of This Interpretation on EITF Issues

A60. The impact of the provisions of this Interpretation on the consensuses in Emerging Issues Task Force (EITF) Issues is discussed in Appendix B.

Other Issues

A61. The Board considered whether this pronouncement should be issued as a Statement of Financial Accounting Standards or as an Interpretation. The Board decided that the guidance in this Interpretation is supported by the standards and expressed intent of existing Board pronouncements and, thus, an Interpretation is the appropriate pronouncement. In issuing this Interpretation, the Board is following the same due process procedures appropriate for issuing a Statement of Financial Accounting Standards.

A62. This Interpretation is principally a clarification and elaboration of paragraph 12 of Statement 5. It also is an Interpretation of Statements 57 and 107 because (a) the Interpretation's paragraph 16 clarifies that some entities for which the controlling financial interest cannot be assessed by analyzing voting interests are related parties subject to the disclosure requirements of Statement 57 (although no detailed guidance is provided) and (b) Statement 107, which requires the disclosure of the fair value of all financial instruments (including financial guarantees issued), specifies illustrative disclosures in paragraph 31 of Appendix B that identify financial guarantees issued as "unrecognized financial instruments" for which fair value must be disclosed. That characterization is modified by the initial recognition and initial measurement provisions of this Interpretation.

A63. Some respondents questioned why the accounting for the guaranteed party was not included in the scope or addressed in the Exposure Draft. They reasoned that because a guarantor would recognize a liability for issuing a guarantee, the guaranteed party should record an asset. The Board noted that the Interpretation was meant to interpret the disclosure requirements of Statement 5 and to clarify that Statement 5 does not prohibit the recognition of a liability when a guarantee is issued. The Board concluded that to address the accounting for the guaranteed party would go beyond an Interpretation of Statement 5.

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Appendix B: IMPACT OF THIS INTERPRETATION ON EITF ISSUES

B1. This appendix discusses the impact of the provisions of this Interpretation on the consensuses reached through October 25, 2002 on EITF Issues. This appendix does not address the impact of this Interpretation on other authoritative accounting literature included in categories (b), (c), and (d) in the GAAP hierarchy discussed in AICPA Statement on Auditing Standards No. 69, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report.*

B2. The provisions of this Interpretation partially nullify the consensuses (or majority views) in the following EITF Issues:

85-20 Recognition of Fees for Guaranteeing a Loan
86-33 Tax Indemnifications in Lease Agreements
89-11 Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan
89-20 Accounting for Cross Border Tax Benefit Leases
95-1 Revenue Recognition on Sales with a Guaranteed Minimum Resale Value
96-21 Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities
00-24 Revenue Recognition: Sales Arrangements That Include Specified-Price Trade-in Rights

The effect of the issuance of this Interpretation will be added to the status section of each affected EITF Issue in *EITF Abstracts*.

B3. Even though the provisions of this Interpretation do not nullify or partially nullify the consensuses in the following EITF Issues, the status section of each of those Issues in *EITF Abstracts* will include a reference to the requirements of this Interpretation:

84-5 Sale of Marketable Securities with a Put Option
84-23 Leveraged Buyout Holding Company Debt
84-37 Sale-Leaseback Transaction with Repurchase Option
85-25 Sale of Preferred Stocks with a Put Option
85-40 Comprehensive Review of Sales of Marketable Securities with Put Arrangements
86-17 Deferred Profit on Sale-Leaseback Transaction with Lessee Guarantee of Residual Value
88-9 Put Warrants

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89-2	Maximum Maturity Guarantees on Transfers of Receivables with Recourse
89-12	Earnings-per-Share Issues Related to Convertible Preferred Stock Held by an Employee Stock Ownership Plan
90-15	Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions
90-20	Impact of an Uncollateralized Irrevocable Letter of Credit on a Real Estate Sale-Leaseback Transaction
91-10	Accounting for Special Assessments and Tax Increment Financing Entities (TIFEs)
92-1	Allocation of Residual Value or First-Loss Guarantee to Minimum Lease Payments in Leases Involving Land and Building(s)
92-2	Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse
93-6	Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises
93-14	Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises
97-1	Implementation Issues in Accounting for Lease Transactions, including Those involving Special-Purpose Entities
97-8	Accounting for Contingent Consideration Issued in a Purchase Business Combination
97-10	The Effect of Lessee Involvement in Asset Construction
97-15	Accounting for Contingency Arrangements Based on Security Prices in a Purchase Business Combination
99-2	Accounting for Weather Derivatives
00-19	Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock
01-12	The Impact of the Requirements of FASB Statement No. 133 on Residual Value Guarantees in Connection with a Lease

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Footnotes

FIN45, Footnote 1--A scope exception from the initial recognition and measurement provisions of this Interpretation is provided in paragraph 7(d) for guarantees for which the guarantor's obligation would be reported as an equity item (rather than a liability) under generally accepted accounting principles (GAAP).

FIN45, Footnote 2--Paragraph 540 of Statement 133 defines an *underlying* as "a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable." The occurrence or nonoccurrence of a specified event (such as a scheduled payment under a contract) is a variable that is considered an underlying under that definition, which is applicable in this Interpretation.

FIN45, Footnote 3--FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* provides disclosure standards and valuation guidance with respect to retained interests from a securitization that are subordinated to more senior interests held by others. Paragraph 59 of that Statement points out that subordination may concentrate the credit and other risks inherent in the transferred assets into the subordinated residual interests and that such concentration would affect the fair value of those subordinated residual interests.

FIN45, Footnote 4--An example of that unusual circumstance is a guarantee for which, at inception, there is a high (probable) likelihood that the guarantor will be required to pay the maximum potential settlement at the end of the six-month term and a low likelihood that the guarantor will not be required to make any payment at the end of the six-month term. The amount that satisfies the fair value objective would include consideration of the low likelihood that no payment will be required, but the accrual of the contingent loss under paragraph 8 of Statement 5 would be based solely on the best estimate of the settlement amount whose payment is probable (the maximum potential settlement amount in this case). This example is considered to be an unusual circumstance because of the high likelihood at inception that the maximum potential settlement amount will be paid, resulting in a substantial initial fair value for that guarantee. Another example in which the contingent liability amount required to be recognized at inception of the guarantee by paragraph 8 of Statement 5 exceeds the fair value at inception would involve an undiscounted accrual under Statement 5 for a guarantee payment that is expected to occur many years in the future.

FIN45, Footnote 5--A commercial letter of credit is a document issued typically by a financial institution on behalf of its customer (the account party) authorizing a third party (the beneficiary), or in special cases the account party, to draw drafts on the institution up to a stipulated amount and with specified terms and conditions; it is a conditional commitment (except when prepaid by the account party) on the part of the institution to provide payment on drafts drawn in accordance with the terms of the document.

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FIN45, Footnote 6--Three parties are typically involved in guarantees of indebtedness. Paragraph 9 of Interpretation 34 originally stated the following:

> Both direct and indirect guarantees of indebtedness involve three parties: a debtor, a creditor, and a guarantor. In a direct guarantee, the guarantor states that if the debtor fails to make payment to the creditor when due, the guarantor will pay the creditor. If the debtor defaults, the creditor has a direct claim on the guarantor. Under an indirect guarantee, there is an agreement between the debtor and the guarantor requiring the guarantor to transfer funds to the debtor upon the occurrence of specified events. The creditor has only an indirect claim on the guarantor by enforcing the debtor's claim against the guarantor. After funds are transferred from the guarantor to the debtor, the funds become available to the creditor through its claim against the debtor.

FIN45, Footnote 7--For example, guarantees can arise from transactions or other arrangements with SPEs, joint ventures, equity method investees, franchisees, employees and members of the entity's board of directors, other related parties, and customers. Guarantees can also arise in conjunction with business combinations.

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