GASB

Memorandum

GASAC Meeting

February 21–22, 2013

To: GASAC Members

From: Deborah Beams, Scott Reeser, Randy Finden, Ken Schermann, and Joe Ammon

C: Board Members, David Bean, GASB Technical Staff, Meeting Observers, and Financial Guarantees Task Force

Date: January 28, 2013

Re: Financial Guarantees Project: Board Redeliberations of Issues Raised in Comments Received in Response to the Exposure Draft, *Accounting and Financial Reporting for Nonexchange Financial Guarantee Transactions*

INTRODUCTION

A summary of comments received in response to the Exposure Draft, *Accounting and Financial Reporting for Nonexchange Financial Guarantee Transaction* (Exposure Draft), was presented and discussed at the November 2012 GASAC meeting. Since then, the Board has been redeliberating the issues raised by respondents. This paper provides an update on the issues discussed to date, and the tentative decisions reached.

The issues presented in this paper have been grouped into four categories: scope, recognition and measurement, recognition of intra-entity transactions, and disclosures. The Board reviewed comments related to scope at its November 2012 meeting, and reviewed recognition and measurement at its January 2013 meeting. The Board will be revisiting recognition threshold issues and discussing recognition of intra-entity transactions at its February 2013 meeting, and discussing comments related to disclosures at its March 2013 teleconference.

SCOPE

At its November 2012 meeting, the Board considered comments regarding the following scope issues:

1. Exclusion of exchange guarantees

   Several respondents raised concerns about inconsistency between guidance for exchange and nonexchange guarantees that would be created based on the proposals in the Exposure Draft. The Board tentatively agreed to retain the exclusion of exchange guarantees, but decided to consider this issue again in connection with its tentative decision in relation to the recognition threshold (as discussed in the next section) at its February 2013 meeting as part of the reconsideration of the recognition threshold.

2. Distinguishing between exchange and nonexchange transactions

   Some respondents requested clarification on transactions that would be considered exchange versus nonexchange, particularly if the consideration received for the guarantee is not commensurate. The Board tentatively decided to specify that exchange-like financial guarantee transactions should be treated the same as exchange transactions that are financial guarantees, and therefore would be excluded from the scope of this project. Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, footnote 1 provides that "The difference between exchange and exchange-like transactions is a matter of degree. In contrast to a "pure" exchange transaction, an exchange-like transaction is one in which the values exchanged, though related, may not be quite equal or in which the direct benefits may not be exclusively for the parties to the transaction. Nevertheless, the exchange characteristics of the transaction are strong enough to justify treating the transaction as an exchange for accounting recognition."

3. Clarification on applicability to specific types of obligations

   The Exposure Draft defined a nonexchange financial guarantee as, "a guarantee of an obligation of a legally separate entity that requires the guarantor to indemnify a third-party entity, the obligation holder, under specified conditions." Some respondents raised questions about the types of obligations that would fall into the scope of the Exposure Draft, based on the definition provided. The Board tentatively agreed to retain the definition of a nonexchange financial guarantee as written in the Exposure Draft. The Board also tentatively agreed that moral obligations, joint and several obligations, and pledges of future revenues should be excluded from the scope, and to specify these decisions in the Basis for Conclusions. Additionally, the Board tentatively agreed that guarantees from the federal government are included within the scope of the project.

DISCUSSION QUESTIONS

1. **Do you agree with the Board's tentative decision to exclude exchange and exchange-like guarantees from the scope of the final Statement (Issues 1 and 2 above)? Why or why not?**

2. **Do you agree with the Board's tentative decisions to retain the definition of a nonexchange financial guarantee as written in the Exposure Draft, and to include guarantees from the federal government but not moral obligations, joint and several obligations, and pledges of future revenues (Issue 3)? Why or why not?**

RECOGNITION AND MEASUREMENT

At its January 2013 meeting, the Board considered comments regarding the following recognition and measurement issues:

1. Recognition—Consideration of qualitative factors

   Many respondents agreed with the requirement to consider qualitative factors in the assessment of probability as to whether a payment will be made as a result of a nonexchange financial guarantee extended, but one respondent thought this may place an undue burden on the guarantor government to seek out that information. The Board tentatively agreed to retain the requirement to consider qualitative factors in assessing the likelihood that a payment will be made in relation to a nonexchange financial guarantee extended. The Board believes that, in most circumstances, qualitative factors assist a government in making a judgment on probability of payment and the government should have access to the necessary information.

2. Recognition—Guidance for groups of guarantees

   Some respondents requested clarification on the wording in the Exposure Draft related to use of historical data in conjunction with other qualitative factors. The Board tentatively proposed a minor rewording of the sentence to indicate that relevant historical data, if any, should be considered along with the qualitative factors.

3. Recognition—Threshold of “more likely than not”

   Many respondents disagreed with the recognition threshold of more likely than not, as used in the Exposure Draft. The Board tentatively agreed to affirm the use of more likely than not as the recognition threshold, as it had concerns about other recognition points being after the point when it is evident that a liability has been incurred. However, the Board plans to consider at the February 2013 meeting the inconsistency this would create in accounting and reporting for exchange and nonexchange guarantees, as the recognition threshold for exchange guarantees is when the likelihood of payment is probable.

4. Measurement—Reporting the minimum amount within a range

   Some respondents questioned measuring the liability at the minimum amount of a range of possible amounts, if no one best estimate could be made. The Board tentatively decided to retain the requirement to use the minimum amount of a range because it is consistent with other authoritative literature.

5. Measurement—Discounted present value

   One respondent disagreed with the requirement to discount the future outflows in measurement of the liability, and several others requested guidance on what discount rate should be used. The Board tentatively decided to retain the discounting requirement and remain silent on choice of a discount rate, noting that a separate project on present value is on its list of potential projects.

6. Recognition – Other issues

In considering other issues raised by respondents, the Board tentatively agreed that specific guidance was not necessary for either recognition of receivables for expected recoveries after a guarantee payment is made or for derecognition of a liability when the likelihood of payment decreases below the recognition threshold. The Board believed the general guidance in the current authoritative literature is sufficient. The Board also tentatively agreed to propose the addition of wording to state that the expense/expenditure associated with recording the liability should be classified in the same manner as grants or financial assistance payments to other entities. Additionally, the Board tentatively decided to make revisions to the wording from the Exposure Draft to clarify the reclassification of the liability previously recognized for its guaranteed obligation and that the guidance is applicable under both the economic resources measurement focus and the current financial resources measurement focus.

DISCUSSION QUESTIONS

3. **Do you agree with the Board's tentative decision to retain the use of "more likely than not" as the recognition threshold (Issue 3 above)? Why or why not?**

4. **Do you agree with the Board's tentative decision to retain the requirement to measure the liability at the minimum amount of a range of possible amounts, if no one best estimate could be made (Issue 4)? Why or why not?**

5. **Do you agree with the Board's tentative decision to retain the requirement to discount measurement of the liability, and remain silent on choice of a discount rate (Issue 5)? Why or why not?**

6. **Do you agree with the Board's other tentative decisions regarding recognition and measurement of the liability (Issues 1, 2, and 6)? Why or why not?**

INTRA-ENTITY RECOGNITION AND MEASUREMENT

At its February 2013 meeting, the Board will be considering issues related to intra-entity recognition and measurement. The major issue is how to address liabilities for nonexchange financial guarantees extended to component units. The Exposure Draft provided that a guarantor recognize a liability when the recognition threshold is met, in addition to the liability for the obligation recognized by the component unit. Several respondents disagreed with this proposal and requested the Board reconsider the perceived double-counting of a liability. The Board will consider three alternatives:

1. Proceed with the guidance from the Exposure Draft, which could result in a liability for the guarantee being reported by one government within a reporting unit (for example, the primary government) and a liability for the original debt beginning reported by another government (for example, a discretely presented component unit) in certain situations.

2. Revise the guidance for guarantors that extend guarantees to component units, to allow a different recognition threshold of when it is required to make a payment on the obligations or when the government has legally assumed the liability for the obligation, whichever occurs first. This could result in a liability not being recorded in the guarantor's stand-alone financial statements.

3. Revise the guidance for the recipient of the guarantee to reduce its liability or record a receivable for the guaranteed obligation at the same time the guarantor records a liability. This could result in premature reduction of that liability or recognition of a gain contingency in the recipient's stand-alone financial statements.

Other issues related to intra-entity guarantees that the Board will discuss relate to: clarification of the scope that it includes guarantees made to component units, whether to include specific guidance on recording any due to/due from balances, whether to include specific guidance on presentation of the intra-entity transactions, and whether to include an illustrative example of an intra-entity guarantee.

DISCUSSION QUESTION

7. The following are alternatives for recognition and measurement of intra-entity liabilities for guarantees:

a. The guarantor recognizes the liability when it meets the recognition threshold, in addition to the liability for the obligation recognized by the component unit (Exposure Draft Proposal)

b. The guarantor recognizes the liability when it is required to make a payment on the obligation or when it has legally assumed the liability for the obligation, whichever occurs first

c. The recipient of the guarantee reduces its liability or records a receivable for the guaranteed obligation at the same time the guarantor records a liability.

Do you favor alternative (a), (b), or (c)? Why?