OVERVIEW OF FASB INTERPRETATION NO. 45 (FIN 45)

Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others

With an Evaluation of its Impact on True Leases and Synthetic Leases

December 2, 2002

FIN 45 was released in November 2002 and provides standards for expanded disclosure and recognition of guarantees and other off balance obligations in financial reporting. The new standard is an interpretation of SFAS 5: *Accounting for Contingencies.* Commencing with financial statements for periods ending after December 15, 2002, all guarantees will need to be disclosed in notes to financial statements, including the nature and amount of a guarantee. For guarantees issued after December 31, 2002, the "fair value" of the obligation must be reported on balance sheet. Existing guarantees will be grandfathered from balance sheet reporting. Placing such a liability on balance sheet, called "recognition," is premised upon a belief that a guarantor has undertaken an obligation to stand ready to perform in the event that specific triggering events or conditions occur. FASB holds that this noncontingent aspect of a guarantee represents a liability. This obligation stands apart from the actual contingent obligation.

- **Scope**. A variety of contractual obligations are covered by FIN 45, including performance guarantees, indemnification agreements, indirect guarantees of the indebtedness of others and guarantees based on a change in an underlying variable related to an asset, liability or equity instrument. Examples include standby letters of credit, guarantees of contractual cash flows, residual value guarantees and tax and environmental indemnities.

  42N Observation: *All types of agreements and indemnifications will be included in the scope of this Interpretation. There is no materiality standard for liabilities. The Interpretation is broad-reaching and principles-based in nature, requiring interpretative analysis and defense by company preparers. Thinly-staffed treasury and controller functions at companies will be challenged to identify corporate obligations and implement the Interpretation after year end combined with other significant standards being implemented by FASB simultaneously.*

- **Scope Exceptions.** Outside the scope of FIN 45 are commercial letters of credit and other loan commitments, lessee guarantees under capital leases, intercompany guarantees, indemnifications or guarantees of an entity's own future performance, payments characterized as contingent rent under SFAS 13 and insurance contracts.

  42N Observation: *Capital lease obligations are excluded since these commitments are normally reflected on balance sheet at their full notional amount.*

- **Disclosure.** Footnote disclosure on all guarantees, including existing guarantees, must be included in financial statements of interim or annual periods ending after December 15, 2002. (For calendar year public companies, disclosure will occur in the Form 10-K filed by March 31, 2003.)

Required information includes the nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events or circumstances that would require the guarantor to perform under the guarantee; the maximum potential amount of future payments the guarantor could be required to make; the current carrying amount of the liability, if any; and the nature of any recourse provisions that would allow the guarantor to recover from a third party or assets held as collateral from which the guarantor could recover amounts paid under the guarantee.

42N Observation: *Companies will have limited time to meet disclosure requirements during the first quarter 2003. Companies will need to quickly catalog guarantees and off balance sheet obligations and the circumstances surrounding those obligations to meet audit and filing deadlines. Disclosure will likely be consolidated in a new footnote to financial statements and may duplicate other disclosures currently made by companies.*

- **Initial Recognition.** Starting with guarantees issued or modified after December 31, 2002, a guarantor is required to recognize, at the inception of a guarantee, a liability for the obligations it has undertaken in issuing the guarantee, namely the ongoing obligation to stand ready to perform over the term of the guarantee.

  Certain guarantees will not be required to be recognized including product warranties, derivatives and intercompany guarantees of subsidiary or parent debt.

  42N Observation: *Recognition is the identification and reporting of an asset or liability on balance sheet. FASB is requiring that a guaranty be recognized as a liability. The Board's premise is that an entity's willingness to stand ready to perform is a liability requiring recognition. The amount to be recognized is not the full value of the guaranty and is described below under Initial Measurement.* ***Existing guarantees as of December 31, 2002 are grandfathered from recognition, unless they are later modified, but they are still required to be disclosed.*** *There is no materiality standard for recognizing a liability. The guarantee need not be probable to be recognized. There does not need to be an actual item of cash flow at inception or in the future in order to be recognized. Unless material, guarantees being recognized would likely appear under "other liabilities" on the balance sheet.*

- **Initial Measurement.** The objective of initial measurement is to determine the fair value of a guarantee at inception. If a premium is received from a third party in exchange for a guarantee, then that premium is the fair value of the liability. In other cases, including when a guarantee is issued as part of a transaction with multiple elements, observable transactions for similar guarantees can be used as a proxy. If no market-based observations exist, then the present value of expected cash flows should be used as the best estimate of fair value.

FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* provides the operative guidance for expected cash flow analysis. It defines expected present value as the "sum of the probability-weighted present values in a range of estimated cash flows, all discounted using the same interest rate convention."

- **Offsetting Entry.** Identification of the offsetting entry for the guarantor's liability is not specified or in the scope of FIN 45, but illustrations of certain circumstances are provided. For example, a residual value guarantee under an operating lease is viewed as prepaid rent.

  42N Observation: *The scope of the Interpretation is narrowly relegated to disclosure and initial recognition. Determination of the offsetting entry will be based on facts and circumstances. Preparers will need to make sound arguments to their auditors. Consideration may be given to the "asset" that the guarantor obtained in exchange for the guarantee. Similar to the liability being recognized, there need not be any actual item of cash flow at inception or in the future that may be derived from the asset.*

- **Subsequent Accounting.** FIN 45 does not specify how a guarantor's liability would be treated subsequent to its initial recognition. The liability would typically be reduced (by a credit to earnings) as the guarantor is released from risk. Depending on the nature of the guarantee, the guarantor's release from risk may occur upon the expiration of the guarantee, by a systematic amortization method or as the fair value changes.

  42N Observation: *Subsequent accounting addresses how the asset and liability may change on the balance sheet during the life of a guarantee and the resultant income statement effect. Subsequent accounting, in this case, need not reflect actual cash flows since those flows would be reported separately based upon actual events. Facts and circumstances with individual liabilities would determine their subsequent accounting. There are a number of possibilities on how guarantees would be treated subsequently, all dependent on the nature of the guarantee. Most prominently, amortizing the asset and the liability over the life of the guarantee is consistent with FASB's view that the amount being recognized is equal to the value of a company's willingness to stand ready to perform. It is possible to remeasure the fair value of the guarantee on later reporting dates and to rebook the asset and the liability, with or without an income statement effect.*

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Example – Residual Value Guarantee
A lessee under a 5-year synthetic lease provides a first loss guarantee of 85% of the value of an asset at the end of lease term. The guarantee arises if the asset is sold to a third party at a price that is less than the lease balance. An appraisal of the asset supports that the estimated fair value of the asset is equal to the amount of the lessee purchase option (also equal to the lease balance) determined at the inception of the lease.

- Initial Recognition and Measurement. The fair value of the residual value guarantee will need to be recognized as a liability. The measurement of fair value will likely be completed through an expected cash flow model since there is no equivalent market guarantee or observable market data. Third party residual value insurance does not cover the first dollar risk of loss and is normally underwritten to a lower and safer level of value. There is no other observable market data, especially for a guarantee that is not part of an embedded contract like a synthetic lease. Therefore, it will be necessary for the lessee-guarantor to obtain data and construct a series of expected cash flows in order to determine the fair value. The table below displays a series of possible values of the asset at the end of five years and the probability of their occurrence (with 100 being the value at which the guarantee would be in effect). The potential outcomes are weighted to determine an expected value of the guarantee.

Possible Outcomes in Value	Payment under Guarantee	Probability of Occurrence	Weighted Expected Value of Guarantee (Undiscounted)
102	0	10%	-
100	0	45%	-
98	2	25%	0.50
95	5	13%	0.65
90	10	5%	0.50
85	15	2%	0.30
Total		100%	1.95

Even though it is probable that there will be no payment under the guarantee, the probability-weighted expected value is 1.95. Values equal to or greater than the guarantee value are ignored since the guarantee would not apply. The resultant expected value must then be discounted at the risk free rate for the five year period. Using the yield for a 5-year U.S. Treasury note of 3.30%, the present value of the expected cash flows would be 1.66.

The fair value of the guarantee is 1.66. This is the amount of the reported liability, not the total guaranty amount of 85.

Observation: *Reported liabilities will likely be small relative to the notional amount of the obligation, but this is consistent with the expectation that the guarantee is unlikely to be called upon. Concerns about large amounts on balance sheet or the earnings impact of these guarantees under leases may be lessened as a result. Nevertheless, the exercise that reporting companies will go through to comply may be cumbersome, time-consuming and expensive relative to the value of information that results from the effort.*

- Offsetting Entry (Asset). This item is not within the scope of the Interpretation, but there is some limited guidance. Specifically, in paragraph 11d of the Interpretation, an example of a residual value guarantee under an operating lease is presented with the offsetting entry being prepaid rent. The basis for this conclusion is that the lessee-guarantor received something in kind for the residual guarantee, namely a reduction in rent. Paragraph 11d identifies that the prepaid rent should be considered a minimum lease payment under SFAS 13.

  Observation: *While 11d will likely be treated as doctrine, an alternative is that the offsetting entry is the fixed purchase option that the lessee received in consideration of the guarantee, conferring all appreciation to the lessee. It may be possible to defend that the asset should be a receivable or option, instead of prepaid rent.*

- Subsequent Accounting for the Liability. This item is not within the scope of the Interpretation nor is any direct guidance given. The expectation is that each situation will be evaluated based upon facts and circumstances. The primary possibilities include:

  - The liability should be held at its original value until guarantee expiration, with periodic tests for impairment.
  - The fair value of the guarantee should be periodically remeasured and the liability adjusted accordingly.
  - The liability should be reduced straight-line over the term of the guarantee.

- Subsequent Accounting for the Corresponding Asset. This item is not within the scope of the Interpretation nor is there any direct guidance given. Again, facts and circumstances will govern how the asset is treated subsequent to its initial entry. Several views are possible to consider for a corresponding asset under a lease:

  - If the asset is prepaid rent and considered a payment in kind for a reduction in rent, then it might be expensed in a straight-line manner over the lease term. In the case of a synthetic lease, additional rent expense would erode the benefit that lessees obtain by eliminating depreciation expense from having fixed assets on balance sheet. However, this expense may be offset by income recognized by a corresponding reduction in the liability.
  - If the corresponding asset is a purchase option, then the option may be revalued and adjusted periodically or held at its original value, with periodic reviews for impairment.

The information contained in this memorandum does not purport to be authoritative guidance on FIN 45 and readers should rely on advice from their own auditors. Opinions expressed herein are strictly the views of 42 North Structured Finance, Inc.

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