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October 11, 2007

LETTER OF COMMENT NO. 1A

Financial Accounting Standards Board  
c/o Technical Director – File Reference No. 1530-100  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: Comments on Exposure Draft: Proposed Statement of Financial Accounting Standards, Accounting for Financial Guarantee Insurance Contracts, an interpretation of FASB Statement No. 60; File Reference No. 1530-100

Ladies and Gentlemen:

We submit this comment letter to supplement and further support our prior comment letter dated May 29, 2007 in response to the Financial Accounting Standards Board's ("FASB") Exposure Draft: Proposed Statement of Financial Accounting Standards, *Accounting for Financial Guarantee Insurance Contracts*, an interpretation of FASB Statement, ("SFAS") No. 60 (the "Exposure Draft").

We believe strongly that by mandating a uniform methodology, the Exposure Draft is a much needed measure to standardize the diverse practices that currently exist with respect to recognizing premium revenue and claim losses in the financial guarantee insurance industry. While we recognize that other commentators and interested parties have raised issues that require FASB's further consideration, we believe that FASB's core positions relating to recognition of premium revenues and claim losses must be protected if the accounting for the financial guarantee industry is to meet the basic goals of transparency, consistency, and full and fair disclosure across the industry.

With respect to premium revenue recognition, we agree with FASB's belief that the economic risks associated with financial guarantees cannot be accurately measured until such time as the underlying risk of loss passes. Regarding the determination and measurement of claim losses, while fully concurring with FASB's approach, we request FASB to provide additional guidance related to (1) the placement of items in an entity's surveillance list, and (2) the disclosure of assumptions used to estimate entity-specific claim liabilities and entity-specific discount rates used to measure claim liabilities.

## Premium Revenue Recognition

Financial guarantee insurance contracts are generally long-term in nature and the risks that are insured are discrete, not continuous. Financial guarantor entities, in fact, effectively guarantee a stream of discrete payments to the holders of debt instruments.

We agree with FASB's viewpoint that the risks cannot be properly measured during the duration of the guarantee, and expire only when the underlying debt service obligations are made. As such, financial guarantor entities should recognize revenues in proportion to the expiration of economic risk, which is presumed to occur as the scheduled debt payments are made. Keeping this characteristic of financial guarantees in perspective, the Exposure Draft appropriately links the insurer's revenue recognition with the diminution of risk to the insurer over the period of the contract. Accordingly, the Exposure Draft posits that the revenue recognized in a given period would be the ratio of contractual payments made during that period by the insured over the total payments to be made by the insured over the life of the contract.

Much of the dissent to the proposed premium methodology focuses incorrectly on the correlation of risk to the passage of time and its purported inconsistency with current accounting guidance especially SFAS No. 60. While recognizing the interplay between risk and the passage of time, it appears that in its deliberations and in formulating the Exposure Draft, FASB rightly concluded that for purposes of recognizing revenue there is no means of perfectly (or sufficiently) correlating the measurement of risk and the passage of time.

In short, in the universe of financial guarantees, the passage of time by itself does not – and cannot – directly translate into dissipation of risk. To the contrary, as discussed in greater detail below, under the terms of most financial guarantee contracts the risk of default and, therefore, exposure to financial guarantors, actually increases over time. Thus, as FASB determined, the proper and logical approach is to tie revenue to the insurer's diminution of risk of payment on the ultimate obligation without placing sole emphasis on the passage of time.

SFAS No. 60 provides that revenue is to be recognized evenly over the contract period in the case of a "short-duration contract"<sup>1</sup> or, for a "long-duration contract,"<sup>2</sup> as the premiums are due from policy holders. The limitation with the guidance in SFAS No. 60 is that in presuming that the risk to the insured diminishes evenly over the life of the contract, it incorrectly places too much emphasis on the passage of time. To the contrary, the Exposure Draft correctly recognizes that, unlike accounting for most other types of insurance, it is not possible to properly measure

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<sup>1</sup> The contract provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided. (SFAS No. 60, paragraph 7a.)

<sup>2</sup> The contract generally is not subject to unilateral changes in its provisions, such as a noncancelable or guaranteed renewable contract, and requires the performance of various functions and services (including protection) for an extended period. (SFAS No. 60, paragraph 7b.)

the risk of default in a financial guarantee insurance policy until the time the risk of loss has passed. We wholeheartedly agree with this sensible and simple approach.

Under GAAP, revenue is generally recognized when (1) it is realized or realizable, and (2) it has been earned. There are, however, precedents that exist in the accounting literature where the presence of uncertainty with regard to the development of reliable estimates or forecasts (*e.g.*, costs incurred or degree of performance completed) would require the postponement or deferral of revenue recognition until the end of the earnings process. We would like to point out the following instances where GAAP permits the use of revenue recognition methodologies to defer revenue because the earnings process has not yet been completed.

- Completed contract method (Statement of Practice No. 81-1, Accounting for Performance of Construction Type and Certain Production Type Contracts)
- Completed performance method for service contracts (FASB Technical Bulletin No. 90-1, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts, Emerging Issues Task Force Issue Nos. 91-9, Revenue and Expense Recognition for Freight Services in Process, and, 01-14, Income Statement Characterization of Reimbursements Received for "Out-of-Pocket" Expenses Incurred, Statement of Practice No. 98-5, Reporting on the Costs of Start-up Activities)
- Collection method for service contracts (same references as completed performance method above)
- Cost recovery method (Accounting Principles Board Opinion No. 10, Omnibus Opinion including Installment Method of Accounting)
- SFAS No. 66, Accounting for Sales of Real Estate
- Deferred gross profit method under SFAS No. 48, Revenue Recognition When Right of Return Exists

### *Completed Contract Method*

Under SOP 81-1, construction contract revenue is generally recognized during construction rather than at the completion of the contract. Termed the percentage-of-completion method, it recognizes revenue as work on a contract progresses. The recognition of revenues and profits is generally related to costs incurred in providing the services required under the contract.

The length of time implicit in long term construction contracts can, however, create uncertainties regarding the estimation of the amount of costs that will be incurred during the life of the contract. Accordingly, when no reasonable estimates can be made about the amount of total costs or inherent hazards cause forecasts to be doubtful, the use of the completed contract method would be preferable. This method allows the reporting entity to defer recognition of all revenues until such time as the contract is complete.

### *Completed Performance Method*

With respect to service transactions, the recognition of revenue is based on performance, because performance determines the extent to which the earnings process is complete or virtually complete. The completed performance method is used when more than one act must be performed and when the final act is so significant to the entire transaction taken as a whole that performance cannot be considered to have taken place until the performance of that final act occurs. For example, a moving company packs, loads, and transports merchandise; however, the final act of delivering the merchandise is so significant that revenue should not be recognized until the goods reach the final destination. If an objective measure for estimating the degree to which performance has taken place cannot be determined, the revenue should be recognized under the completed completion method.

### *Collection Method*

The collection method is used for service transactions in circumstances when there is a significant degree of uncertainty surrounding the collection of service revenue. Under this method, revenue should not be recorded until the cash is collected. For example, personal services may be provided to a customer whose ability to pay is uncertain.

### *Cost Recovery Method*

GAAP allows for the use of the cost recovery method in installment sales situations where substantial doubts exist regarding the collectibility of the sales price. Under this method, gross profit is deferred until such time as all costs have been recovered. Once the seller has recovered all costs, any subsequent cash receipts are included in income.

### *Real Estate Sales under SFAS No. 66*

Profit from real estate sales may be recognized in full provided the following two conditions exist:

1. The profit is determinable (*i.e.*, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated).
2. The earnings process is virtually complete, that is, the seller is not obligated to perform significant activities after the sale to earn the profit.

If both these conditions are not met, recognition of all or part of the profit should be postponed.

### *Deferred Gross Profit Method under SFAS No. 48*

SFAS No. 48 provides that where the amount of returns from the sale of a product cannot be reasonably estimated, deferral of the revenue is appropriate until such an estimate can be made. As such, the gross profit from a sale is recognized in future periods when the uncertainty surrounding the collection of the sales price passes.

To summarize, the above examples serve to demonstrate that FASB's conclusions in the Exposure Draft regarding revenue recognition by financial guarantors are consistent with existing accounting theory and practice – particularly in situations where the mere passage of time does not dictate economic outcomes. As such, FASB has relied on precedents that have long existed in accounting guidance in formulating the Exposure Draft. Accordingly, if significant uncertainties exist and/or a final act is so significant that performance cannot be considered to have taken place until the final act occurs, then the recognition of revenue has to be deferred. We believe that in the financial guarantee universe, the uncertainties relating to diminution of risk are such that consideration of the passage of time would be an inappropriate basis for revenue recognition.

A case in point relates to disagreements in some comment letters surrounding the recognition of premium revenue in total at maturity, for example, in the case of a zero coupon bond. Critics have tried to argue that that waiting until maturity to recognize revenue might not reflect the reduction of risk with passage of time.

In addressing this issue, FASB rightly observed that there might not be a reduction of the economic risk associated with the insured financial obligation until maturity, when the insured contractual payments are made by the issuer of the insured financial obligation.<sup>3</sup> In fact, the risk of failure to payout on guaranteed obligations is highest when the principal is due and the underlying obligor must access the capital markets to refinance its obligation. Reference to the recent turmoil in the credit markets highlights the fact that obligors may simply be shut out of the credit markets even if those obligors are marketing loans that historically have been viewed as “safe” or low-risk.

Also, as explained earlier in this letter, one can analogize the payment of the zero coupon bond at maturity to the completed performance method wherein the final act – the payment at maturity – is so significant to the entire transaction taken as a whole that performance cannot be considered to have taken place until the performance of that final act occurs. Therefore, in this instance revenue should be deferred until the risk of loss ultimately passes, which occurs upon payment at maturity.

In our review of industry-sponsored comment letters to the Exposure Draft, we believe that some industry participants reached too far in their arguments in favor of a time-based revenue recognition approach. Take, for instance, typical financial guarantee infrastructure projects such as the construction of a new toll road. We were puzzled to read an industry proponent's argument that a typical infrastructure project's risk profile argues in favor of a time-based revenue recognition approach. Under their view, the normal pattern of risk in infrastructure projects was higher construction risk in early stages and greater amortization near the end of the guarantee's term. Consequently, this view suggests that the Exposure Draft's approach would cause too little revenue to be recognized up front relative to the economic risks

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<sup>3</sup> Exposure Draft, paragraph B16.

of the project which were suggested to be high in early stages.

We believe that this view is fundamentally mistaken. It incorrectly conflates project execution risk and financial risk to a guarantor. A simple illustration makes the point: A toll-road authority issues \$300 million in guaranteed bonds to fund the construction of a new toll road. Immediately after the placement, the bond issuer is flush with cash sufficient to fund early construction costs as well as interest payments on the bonds. The notion that the issuer is at greater risk of defaulting on the bonds in the early stages, thereby imposing risk on the underlying guarantor, makes little sense in light of the liquid capital immediately available to the bond issuer. This is true even if construction costs in early stages are higher than originally anticipated.

In addition, with respect to most infrastructure projects, to minimize risk sponsoring toll authorities or municipalities engage in comprehensive bidding processes to identify the most cost-efficient general contractors, which tend to be large and well capitalized. Thereafter, the parties enter into firm, fixed-priced construction agreements to protect against budget overruns. We are unaware of any instance where a guaranteed infrastructure project bond issuance defaulted on interest payments during the construction phase of such a project. Moreover, a typical infrastructure project's budget, such as the construction of a toll road, would anticipate low-adoption rates in early years among motorists and build into the repayment schedule some sort of early grace period or payment cushion.

Using the same example, consider the later-year risk profile of the hypothetical toll road project. After construction, the bulk of the \$300 million will have been depleted. At that stage, bondholders (and the bond guarantor) would have to rely on the operation of the toll road to fund interest payments. If, despite contractual protections, the toll road's construction ran over budget, or motorist adoption rates are lower than expected, the ability of the issuer to make bond interest payments as they are due may be at risk. In other words, for such projects, the risk of interest payment defaults in later years is substantially higher than in early years.

Financial guarantees of structured finance and derivative products (*e.g.*, asset backed securities and collateralized debt obligations) share many similar features to protect against default risk in early periods. Typically, financial guarantors insure only the most senior tranches of these securities. Beyond the subordination of lower, higher risk tranches, normally these securities are initially over-collateralized, have built-in reserves and excess spread income that provide a payment cushion. Taken together, these features virtually assure that no payment defaults will occur in early periods after issuance. Over time, however, defaults in the underlying collateral erode these structural protections, thereby increasing the probability of defaults in later years.

Taking into account the risk profile of interest payment default over time, the foregoing analysis suggests that a payment risk-related and not time-related criterion should be central to the accounting treatment.

We have reviewed the balance of the countervailing considerations raised in various other industry-related comment letters. The arguments set forth in those letters appear to be many of the same that were promoted during the course of FASB's deliberations over the last several years. We commend FASB for diligently considering and discussing many possible scenarios before reaching its conclusions.

### **Claim Losses Recognition and Measurement**

The Exposure Draft would require an insurer to recognize a claim liability on a contract when it expects that a claim loss will exceed the unearned premium revenue for the contract based on expected cash flows. The claim liability is to be initially measured based on the present value of expected cash flows discounted using a risk adjusted rate at the initial recognition of the liability. The risk adjusted rate is to be based on the risk free rate adjusted for the credit standing of the insurance enterprise.

A financial guarantee insurance company is permitted to calculate expected cash flows using its own assumptions based on the information available to it from, among other sources, a surveillance list maintained to evaluate credit standing of any insured financial obligation. Notwithstanding the claim loss methodology presented in the Exposure Draft, we believe that allowing management judgment to dictate what information is to be included in the surveillance list may lead to the use of arbitrary practices, which in some cases, might open the door for financial statement manipulation. In that regard, we would encourage FASB to go further and provide a uniform set of criteria which all insurers must consider to place obligations in their respective surveillance lists. Further, we would request FASB to provide additional guidance related to the disclosure of assumptions used to estimate entity-specific claim liabilities and entity-specific discount rates used by entities to measure claim liabilities. Standardization in loss recognition assumptions and the clear disclosure of those assumptions is essential to accomplishing the goals of transparency and consistency in this area.

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In sum, we believe that the Exposure Draft provides a reasonable basis to account for financial guarantee insurance contracts by attempting to link the underlying economics of the transactions and risks associated therewith. We strongly endorse the new approach that FASB has developed and congratulate FASB and its staff for a job well done.

PERSHING SQUARE CAPITAL MANAGEMENT, L.P.

Very truly yours,



William A. Ackman