Financial Accounting Standards Board

Board Meeting Handout
Insurance Contracts
November 20, 2012

PURPOSE OF THE MEETING

1. The purpose of this meeting is to discuss when guarantee contracts that meet the definition of insurance should be accounted for in accordance with the proposed insurance contracts standard.

Background

2. In the insurance contracts project, the FASB has defined the term *insurance contract* as a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. *Insurance risk* is defined as risk, other than financial risk, transferred from the holder of a contract to the issuer. And finally, *financial risk* is defined as the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating, credit index, or other variable provided that, in the case of a nonfinancial variable, the variable is not specific to a party to the contract.

3. A *guarantee* is a contractual arrangement in which one party agrees to pay another party if specified events or conditions occur. If the guarantor is at risk of a loss for an event that adversely affects the guarantee holder, then the guarantee would meet the definition of insurance. The result of applying this definition is that the scope of contracts that are within the insurance contracts project would be expanded to include contracts and to apply to entities that it had not previously.

4. Under current accounting, selection of the appropriate guidance is dependent, at least in part, on the type of entity issuing a guarantee. As a result of the dependence on business models, similar if not identical contracts are sometimes accounted for differently simply because of the nature (that is, insurer versus noninsurer) of the

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issuing entity. Guarantees are currently accounted for as insurance under Topic 944, Financial Services—Insurance, as guarantees under Topic 460, Guarantees, or as derivatives under Topic 815, Derivatives and Hedging. Many preparers disagree with the entity-specific nature of the guidance, particularly those who compete for capital with other entities that might get seemingly favorable treatment. However, several constituents have argued that financial guarantees are more characteristic of other financial instruments and should fall within the scope of other projects.

5. The staff reviewed existing guidance to identify similarities and differences between the proposed insurance contracts guidance and today's accounting for any guarantees that are not accounted for under general insurance guidance (that is, any guarantees currently accounted for under Topic 460, Topic 815, or Topic 944 portions that were originally issued as FASB Statement No. 163, *Accounting for Financial Guarantee Insurance Contracts*).

Guidance for NonInsurance Entities Compared with Proposed Guidance

6. The table below summarizes the differences between Topic 460 and the proposed insurance contracts model:

	Topic 460	Differences with Insurance Model
Initial recognition	Requires measurement of the liability on day one at fair value: the amount of the liability "should be the premium received or receivable by the guarantor as a practical expedient"	None—the liability is calibrated to the premium received or the receivable
Subsequent measurement (recognition of premium)	The initially recognized liability should typically be reduced as the guarantor is released from risk under the guarantee. The release from risk is typically recognized over the term of the guarantee and depending on the guarantee may be released (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	Could be analogized to the Board's tentative decision on releasing the liability for remaining coverage under the Premium Allocation Approach (PAA). The insurer should reduce the measurement of the liability for remaining coverage over the coverage period as follows: a. On the basis of time, but b. On the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time. Also could be analogized to the Board's tentative decisions on recognizing the single margin as the insurer satisfies its performance obligation to

		compensate the policyholder; as it is released from exposure to risk as evidenced by a reduction in the variability of cash flows. Another analogy could be to the Board's tentative decision regarding the recognition of premiums and claims presented in an insurer's statement of comprehensive income for contracts accounted for under the Building Block Approach (BBA). That is, premiums are allocated to periods in proportion to the value of coverage (and any other services) that the insurer has provided in the period and claims are presented when incurred.
Subsequent measurement (recognition of liability for guarantee)	Topic 405, Liabilities, is applied for subsequent adjustment of guarantees initially recognized under Topic 460. Paragraph 405-30-25-1 requires entities to recognize liabilities when all of the following conditions are met: • Probability of assessment: an assessment has been imposed or information available before the financial statements are issued or are available to be issued indicates it is probable that an assessment will be imposed. • Obligating event: the event obligating an entity to pay (underlying cause of an imposed or probable assessment has occurred on or before the date of the financial statements). • Ability to reasonably estimate: the amount of the assessment can be reasonably estimated.	Assumptions are updated at each reporting date based on changes in expectations versus an "incurred" approach under Topic 460.

7. Based on the above analysis of the differences in the current accounting for guarantees under Topic 460 and the proposed insurance contracts standard, the staff notes that the tentative decisions reached in the insurance contracts project would be an improvement in the accounting for contracts that currently fall into Topic 460 and meet the definition of insurance, specifically because the subsequent measurement of the liability would be based on expected cash flows rather than on an incurred basis. The Board has not only moved toward an expected cash flow basis in the insurance contract project but also in the financial instruments impairment project. One of the primary concerns of applying an incurred model was the delayed recognition of credit losses. The expected loss model is intended on providing more forward-looking information over recognizing the loss based on a specific triggering event, line of determination, or potentially arbitrary threshold.

The staff notes that those reasons hold true for the recognition of a liability for a guarantee contract.

8. The table below summarizes the differences between Topic 815 and the proposed insurance contracts model:

	Topic 815	Differences with Insurance Model
Initial recognition	Requires measurement of the liability on day one at fair value	Differs based on: • Entity-specific data versus market data • Discount rate.
Subsequent measurement	Adjusted to fair value at each reporting date	Fair value is an estimate of the current exit value (that is, as if transferring the contract to a market participant). Fulfillment value is an estimate of the current value of the amount the insurer expects to pay over the life of the contract.

9. Based on the above analysis of the differences in the current accounting for guarantees under Topic 815 and the proposed insurance contracts standard, the staff notes that the tentative decisions reached in the insurance contracts project would not be an improvement in the accounting for contracts that currently fall into Topic 815, specifically because those arrangements are already updated at each reporting period to fair value. The effect of measuring those contracts at a fulfillment value would presumably not be that material and the costs to change the accounting would not outweigh the benefits.

Guidance for Insurance Entities Compared with Proposed Guidance

10. Statement 163 (codified in Topic 944) was issued in May 2008 for the purpose of addressing the diversity in practice that existed in accounting for financial guaranty insurance contracts. Prior to the issuance of Statement 163, financial guarantee insurance contracts were accounted for under FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises. Under Statement 60, losses were not required to be recorded until they were incurred when applying the short-duration model, which some insurers interpreted to mean only upon default of the insured obligation. Statement 163 clarified that those losses and the related claims liabilities

should be recorded prior to an insured event if the credit quality of an insured financial obligation deteriorates. The purpose of the analysis below is to determine to what extent Topic 944 (formerly Statement 163) differs from the proposed insurance contracts guidance.

11. The tables below further summarize the differences between Topic 944 and the proposed insurance contracts model:

	Topic 944	Differences with Insurance Model
Initial recognition	The present value of premiums due over the life of the contract or expected to be collected if prepayments are expected, discounted using a risk-free rate	None—the liability is calibrated to the premium received or receivable
Subsequent measurement—remaining obligation	The initial obligation is adjusted at each reporting date for changes in prepayment assumptions, if applicable, with a corresponding adjustment to the receivable and by the amount of revenue recognized. Therefore, the remaining obligation is based on the remaining insurance obligation to be provided.	Potentially little: could be analogized to the Board's tentative decisions on the premium allocation approach. The current method of recognizing the unearned premium reserve (UPR) could be viewed as analogous to the insurer being released from risk: • If the insured principal is paid over time, the insurer is released from risk as the principal amounts outstanding are reduced • If the insured principal is paid at the end of the contract, the insurer is released from risk over time based on there being no changes in assumptions regarding the expected cash outflows for default. However, one could analogize current accounting to unlocking the margin. Discount rate is risk-free rate. In practice, update discount rate on outflows every period (see comments in subsequent measurement—claims liability); lock-in discount rate on inflows at inception of the contract unless there is a significant change.
Subsequent measurement—claims liability	Recognized only if the present value of a claim (that is, the expected cash outflows for a default) is expected to exceed the amount of the remaining UPR, and the corresponding amount of UPR should be recognized as revenue. The claims liability is measured based on the present value of the probability-weighted estimate (that reflects the likelihood of all possible outcomes) of expected net cash outflows to be paid under the insurance contract. The claim liability is remeasured at each reporting date based on increases (or decreases) in the likelihood	The proposed model would require a change in expected cash flow to be recorded to the statement of comprehensive income (assuming the margin is not unlocked). No difference in the measurement of the liability other than the discount rate, which would be based on the characteristics of the liability with impacts in changes from the initial discount rate recorded to other comprehensive income.

	of a default (insured event) (and related amounts of net cash outflows) and potential recoveries with changes recorded to the statement of comprehensive income. The claim liability cannot be reduced below zero. The liability is discounted using a current risk-free rate based on the remaining period (contract or expected, as applicable) of the insurance contract at each reporting date. The discount amount is accreted on the claim liability through the statement of comprehensive income.	

12. Based on the above analysis of the differences in the current accounting for financial guarantees that fall within the scope of Topic and the proposed insurance contracts standard, the staff notes that the tentative decisions reached in the insurance contracts project would be an improvement. Some stated that the insurance contracts model would provide more transparency to users when circumstances have changed such that the insurer expects a claim for an insured event that is expected to occur because it will be recorded as such in the statement of comprehensive income. In addition, some add that a discount rate that reflects the characteristics of the liability would be more appropriate.

Distinguishing Characteristics of Guarantee Contracts

13. Based on the staff's understanding of the various types of guarantees and feedback received from constituents, it has identified and analyzed characteristics that differentiate one type of guarantee from another and that might justify differing accounting treatment in some cases.

Separability (That Is, the Insurer Is Not Exposed to Risk Throughout the Term of the Guarantee)

14. The definition of the term *insurance contract* as tentatively decided by the Board states that an insurance contract obligates one party to "compensate [the other party] if a specified uncertain future event adversely affects [that party]". Embedded in that definition is the notion that the holder of an insurance contract must have an insurable interest covered by the contract. That is, an entity cannot

purchase insurance coverage for an object or person if it does not stand to suffer a loss should that object or person be negatively impacted. Simply, if a policyholder suffers a loss due to the occurrence of an event or condition that is covered by the insurance contract, the insurer is obligated to make them whole (at least to the extent indicated in the contract).

15. The staff notes that if a guarantee contract is structured in a manner that allows for the guarantee to be sold or otherwise transferred separately from the guaranteed asset or liability (even if such sale or transfer has not actually occurred), then the purpose of the guarantee is more than to simply protect the holder from losses resulting from the occurrence of a specified adverse event and, thus, different accounting is warranted.

16. Ideally, the guarantee would be accounted for as insurance when the entity is exposed to risk and as a derivative when the entity is not. However, constituents have indicated that tracking the guarantee and the underlying may be very complex. That characteristic also is consistent with paragraph 815-10-15-58.

17. In addition, that characteristic would encompass suggestions that the staff received in outreach meetings including the following items: the guarantee requires that the holder suffers a loss, the guarantee covers the guaranteed asset/liability for the duration of its life, and the holder is required to maintain custody of the guaranteed asset/liability.

Settlement of the Guarantee Creates a New Transaction

18. Some guarantees provide that the issuer will enter into a future transaction that may be simultaneous with an event occurring or not occurring; for example, the guaranteed party does not perform. That differs from a guarantee that one party will perform in accordance with contractual terms of a past transaction.

19. The staff notes that a commitment for a future transaction is more similar to a forward contract versus a knock-on effect of a past transaction. For example, under a typical insurance contract the insurer compensates the policyholder for their loss on something the policyholder owns (that is, a car or house) or on the

policyholder's health or life. The insurer pays the policyholder, or a third party such as the policyholder's beneficiary or the party injured by the policyholder. A new transaction is not entered into upon payment of the claim. While the insurer typically has the right to the underlying assets, for example, a totalled automobile, this is salvage that the insurer has a right to based on the contractual terms of the contract. Those same concepts hold true for mortgage guaranty insurance in which a mortgage needs to be outstanding or a financial guarantee in which the financial instrument has been issued.

20. At the June 22, 2011, Board meeting, the FASB tentatively decided that standby letters of credit are within the scope of the financial instruments project because they are characteristic of loan commitments. The letters of credit are considered by some as a prearranged loan because the letter of credit essentially guarantees a future loan to an entity if a third party draws down on the letter of credit. Based on our preliminary analysis, standby letters of credit and commercial loan commitments meet the definition of an *insurance contract* because such instruments transfer significant insurance risk (that is, default risk, which has been deemed nonfinancial) from the guaranteed party to the issuer of the instrument. However, because the loan would be considered the new transaction created upon settlement of the guarantee, the letter of credit would be excluded from the insurance contracts project when applying this criterion.

Guarantees of an Entity's Own Performance

21. Some guarantees provide a guarantee on the entity's own performance such that there will be some compensation if that guarantee is not met. Typically, those guarantees provide for a reduction in fees if an entity does not meet a contractual level of performance.

22. Some may not think that the guarantee of an entity's own performance meets the definition of insurance because it is not compensating the guaranteed party for a specified uncertain future event that adversely affects the policyholder. However, others note that the performance guarantees were included in the contractual agreement because of the adverse affect.

23. Regardless of whether one thinks that those types of guarantees meet the definition of insurance, the staff notes that those guarantees should not be accounted for under the insurance model because it views these performance guarantees as warranty-type arrangements that guarantee product performance.

Specific Exclusions

24. The following is an analysis of types of guarantee contracts specifically excluded from Subtopic Topic 460-10, Guarantees—Overall:

(a) A guarantee or an indemnification that is excluded from the scope of Topic 450, Contingencies. Paragraph 450-20-15-2: The following transactions are excluded from the scope of this Subtopic because they are addressed elsewhere in the *FASB Accounting Standards Codification*®:	
(i) Stock issued to employees, which is discussed in Topic 718.	Recorded at fair value as a liability or equity (depending on satisfaction of criteria) over the period of service. The staff does not think this meets the definition of insurance.
(ii) Employment-related costs, including deferred compensation contracts, which are discussed in Topics 710, 712, and 715. However, certain postemployment benefits are included in the scope of this Subtopic through application of paragraphs 712-10-25-4 through 25-5.	Accrue a liability over the period of services, except in some limited situations estimate when an event occurs and whether the amount of payout is probable (that is, employee is still eligible for benefits but is no longer providing service because of permanent disability). The staff does not think this meets the definition of insurance.
(iii) Uncertainty in income taxes, which is discussed in Section 740-10-25.	A tax liability or asset (current and/or deferred) is recognized for the estimated current and future tax effects when it is more likely than not that it will be recognized. The staff does not think this meets the definition of insurance.
(iv) Accounting and reporting by insurance entities, which is discussed in Topic 944.	N/A – insurance is within the insurance contracts project.
(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 Subtopic 840-30.	Addressed in leases project—included as part of the lease liability as lease payments.
(c) A contract that meets the characteristics in paragraph 460-10-15-4(a) but is accounted for as contingent rent under Subtopic 840-30.	Addressed in leases project—Not included in the measurement of the lease liability because it is a variable component.

(d) A guarantee (or an indemnification) that is issued by either an insurance entity or a reinsurance entity and accounted for under Topic 944 (including guarantees embedded in either insurance contracts or investment contracts).	N/A – insurance is within the insurance contracts project.
(e) A contract that meets the characteristics in paragraph 460-10-15-4(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.	Addressed in revenue recognition project—Estimate transaction price using expected value or most likely amount. The cumulative amount of revenue the entity recognizes to date shall not exceed the amount to which the entity is reasonably assured to be entitled (current guidance treats rebates as a reduction to the sales price or as a liability).
(f) A contract that provides for payments that constitute a vendor rebate (by the guarantor) based on the volume of purchases by the buyer (because the underlying relates to an asset of the seller, not the buyer who receives the rebates).	
(g) 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.	
(i) A seller's guarantee of the return of a buyer's investment or return on investment of a real estate property as discussed in paragraph 360-20-40-41.	If guarantee is for an extended period, transaction accounted for as a financing, leasing, or profit-sharing arrangement; If guarantee is for a limited period, deposit method is used and then recognized on the basis of performance of the services required.
(ii) A seller's guarantee of a specified level of operations of a real estate property, as discussed in paragraphs 360-20-40-42 through 40-44.	
(iii) A transaction that involves sale of a marketable security to a third-party buyer with the buyer's having an option to put the security back to the seller at a specified future date or dates for a fixed price, if the existence of the put option prevents the transferor from accounting for the transaction as a sale, as described in paragraphs 860-20-55-20 through 55-23.	Accounted for as a derivative under Topic 815.
(iv) A seller-lessee's residual value guarantee if that guarantee results in the seller-lessee deferring profit from the sale greater than or equal to the gross amount of the guarantee (see paragraphs 840-40-55-26 through 55-28).	Account for as a lease—addressed in leases project.
(v) A sales incentive program in which a manufacturer contractually guarantees that the purchaser will receive a minimum resale amount at the time the equipment is disposed of, if that guarantee prevents the manufacturer from being able to account for a transaction as a sale of an asset, as described in paragraphs 840-10-55-12 through 55-25. (Because a manufacturer continues to recognize the residual value of the equipment it guaranteed [it is included in the seller-lessor's net investment in the lease], if the sales incentive program qualified to be reported as a sales-type lease, it still would not be within the scope of this Topic because this Topic does not apply to a guarantee for which the underlying is related to an asset of the guarantor.)	Account for as a lease—addressed in leases project.
(h) A registration payment arrangement within the scope of Subtopic 825-20 (see	Accounted for separately from

	Section 825-20-15). A registration payment arrangement requires the issuer to provide consideration to the counterparty if the contractual event that calls for the payment of the consideration occurs.	financial instruments subject to contingencies guidance in Subtopic 450-20, Contingencies—Loss Contingencies. The Board specifically scoped these out of AFI. The staff does not think this meets the definition of insurance.
(i)	A guarantee or an indemnification of an entity's own future performance (for example, a guarantee that the guarantor will not take a certain future action).	Proposed characteristic to scope out of insurance contracts project
(j)	A guarantee that is accounted for as a credit derivative at fair value under Topic 815.	Accounted for as a derivative. Criteria is consistent with proposed characteristic to scope out of insurance contracts project

25. In addition, Subtopic 460-10 includes a scope exception only from the initial recognition and initial measurement provisions of the standard for the following items:

a. A guarantee that is accounted for as a derivative instrument at fair value under Topic 815.	Based on the staff's proposed characteristics to be scoped out of insurance contracts guidance, this item would not be accounted for as insurance.
b. A product warranty or other guarantee for which the underlying is related to the performance (regarding function, not price) of nonfinancial assets that are owned by the guaranteed party (see paragraph 460-10-15-9 for related guidance).	The Board has already provided a scope exception in the insurance contracts guidance.
c. A guarantee issued in a business combination or an acquisition by a not-for-profit entity that represents contingent consideration (as addressed in Subtopics 805-30 and 958-805).	The Board has already provided a scope exception in the insurance contracts guidance.
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) (see Topics 480 and 505).	The insurance contracts project is about measuring the liability. If GAAP reports the guarantee as equity then it should be scoped out of insurance.
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 840-30-40-5. This exception shall not be applied by analogy to secondary obligations that are not accounted for under that paragraph.	The staff believes this is addressed in the leases project.

26. Based on the analysis above, the staff notes that the majority of the items explicitly scoped out of Topic 460also should be scoped out of the proposed

insurance contracts standard because the Codification contains specific guidance for those items, some of which have been recently discussed in other current projects (that is, leases and revenue recognition). However, the staff do not believe that some of the items explicitly scoped out of ASC Topic 460 meet the definition of insurance and therefore do not need to be specifically scoped out of the insurance contracts standard.

Other Characteristics Considered but Rejected by the Staff

27. *Credit Risk:* Some constituents, particularly noninsurers, note that in addition to financial risks (as defined in paragraph **Error! Reference source not found.**), the existence of credit risk distinguishes a noninsurance guarantee from a guarantee that should fall under the proposed insurance contracts standard. The staff considered whether the definition of financial risk should be modified to include credit risk. In the basis for conclusions in the IASB Exposure Draft, *Insurance Contracts*, the IASB concluded the following in paragraph BC194 regarding coverage against credit defaults:

> *These contracts transfer credit risk. Some view all contracts that transfer credit risk as financial instruments. However, a contractual precondition for a payment under the contracts… is that the holder has suffered a loss- a distinguishing feature of insurance contracts. Therefore... the definition of an insurance contract should continue to capture these contracts and that they should be within the scope of the draft [standard].*

The staff notes that including credit risk in the definition of financial risk (and, thus, scoping out of insurance risk and therefore out of the accounting guidance for insurance contracts) would be improper because guarantees that protect against default act as insurance (that is, they promise to compensate a holder for losses suffered as a result of the occurrence of a specified event).

28. *Whether or not the guaranteed asset/liability is a financial instrument:* the staff notes that this characteristic would not serve as a viable distinguishing feature because the nature of the guaranteed obligation is not indicative of the type of risk involved in the contract. For instance, a guarantee could protect a creditor

from risk of default (that is, nonfinancial risk) or changes in the creditworthiness of the debtor (that is, financial risk); however, in both cases the guaranteed liability is a financial instrument.

29. *Whether the guarantor has the ability to reprice the guarantee based on specific events or changes in variables:* The staff notes that this characteristic would not serve as a viable distinguishing feature because the presence of this ability alone would not identify a guarantee as either insurance or noninsurance. The contract boundary in the insurance contracts project would indicate that if a guarantee were repriced, one contract would end and a new one would begin. Both the old and the new contracts could be insurance or not, but this characteristic would not determine which ones are insurance.

30. *Whether the guarantee is revocable by the guarantor:* The staff notes that consideration of such a feature is not relevant to the scope of the insurance contracts project because instruments that contain this feature would be more characteristic of loan commitments than guarantees. A fundamental characteristic of all guarantees, whether insurance or not, is that the guarantor commits to *stand ready* to perform, which would not be the case for financial instruments that are revocable by the guarantor. Therefore, if revocable by the issuer, the staff notes that the guarantee would not meet the definition of insurance.

31. *Whether the guarantee provides for a guarantee of performance other than payment of debt:* The notes that this characteristic would not serve as a useful distinguishing feature. The nature of the performance is irrelevant in determining whether a guarantee is insurance.

PRACTICAL RESULTS OF CRITERIA APPLIED TO COMMON GUARANTEES

32. The staff analyzed the anticipated outcome of applying the recommendations to a selection of common guarantees. Based on this analysis, the staff recommends that all guarantees, except those that are currently accounted for as derivatives (including, mortgage guarantees, performance bonds, auction rate securities

guarantees, trust preferred securities guarantees, whole loan sale sales guarantees, indemnities, guarantees on securitized assets, merger and acquisition guarantees, minimum revenue guarantees, residual value guarantees, etc.), would be accounted for under the proposed insurance contracts guidance unless:

(a) The insurer is not exposed to risk throughout the term of the guarantee. That is from inception of the contract and throughout its term either through direct legal ownership of the guaranteed obligation or through a back-to-back arrangement with another party that is required by the back-to-back arrangement to maintain direct ownership of the guaranteed obligation.

(b) Settlement of the guarantee creates a new transaction.

(c) A guarantee or an indemnification is of an entity's own future performance.

(d) The guarantee is addressed in specific areas of the Codification.

Question 1: Scope of the insurance contracts guidance for guarantees

Does the Board agree that:

The proposed insurance contracts standard should not apply to guarantee contracts that have any of the following characteristics:

a. The insurer is not exposed to risk throughout the term of the guarantee. That is from inception of the contract and throughout its term either through direct legal ownership of the guaranteed obligation or through a back-to-back arrangement with another party that is required by the back-to-back arrangement to maintain direct ownership of the guaranteed obligation.

a. Settlement of the guarantee creates a new transaction.

b. A guarantee or an indemnification is of an entity's own future performance.

c. The guarantee is addressed in the following areas of the Codification, including:

1. Guarantees addressed in Topic 840 regarding leases:
   i. A lessee's guarantee of the residual value of the leased property at the expiration of the lease term.

ii. A contract that is accounted for as contingent rent.

iii. A seller-lessee's residual value guarantee if that guarantee results in the seller-lessee deferring profit from the sale greater than or equal to the gross amount of the guarantee.

iv. A sales incentive program in which a manufacturer contractually guarantees that the purchaser will receive a minimum resale amount at the time the equipment is disposed of, if that guarantee prevents the manufacturer from being able to account for a transaction as a sale of an asset, as described in paragraphs 840-10-55-12 through 55-25. (Because a manufacturer continues to recognize the residual value of the equipment it guaranteed [it is included in the seller-lessor's net investment in the lease], if the sales incentive program qualified to be reported as a sales-type lease, it still would not be within the scope of this Topic because this Topic does not apply to a guarantee for which the underlying is related to an asset of the guarantor.)

v. 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 840-30-40-5. This exception shall not be applied by analogy to secondary obligations that are not accounted for under that paragraph.

2. A contract that 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 or based on the volume of purchases by the buyer, which are discussed in Topic 605.

3. 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.

4. Guarantees addressed in Topic 360 on real estate property:

i. A seller's guarantee of the return of a buyer's investment or return on investment of a real estate property.

ii. A seller's guarantee of a specified level of operations of a real estate property.

5. A transaction that involves sale of a marketable security to a third-party buyer with the buyer's having an option to put the security back to the seller at a specified future date or dates for a fixed price, if the existence of the put option prevents the transferor from accounting for the transaction as a sale, as described in paragraphs 860-20-55-20 through 55-23.

6. A guarantee for which the guarantor's obligation would be reported as an equity item rather than a liability under GAAP (see Topics 480 and 505).

CONSIDERATIONS FOR GUARANTEES AMONGST OR ON BEHALF OF RELATED ENTITIES

38. Current guidance indicates that an entity should comply with only the disclosure provisions of Topic 460 (that is, recognition and measurement provisions are not applicable) for guarantees on behalf of or between related parties. FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* specifically included a scope exception from initial recognition and initial measurement provisions for the following:

    (a) A guarantee issued either between parents and their subsidiaries or between corporations under common control

    (a) A parent's guarantee of its subsidiary's debt to a third party (whether the parent is a corporation or an individual)

    (b) A subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

39. The logic behind excluding such obligations from the recognition and measurement requirements in consolidated financial statements is that any such transactions should be eliminated in consolidation. In addition, the Board noted that no arm's-length transaction exists when any of these parent-subsidiary (or common control) guarantees are made because the parent contracts the resources that affect whether the triggering event occurs, which would require the guarantor to perform under a guarantee.

40. However, intercompany insurance agreements are common for entities that are predominantly noninsurance but may have an insurance subsidiary to essentially self insure the entity and intercompany reinsurance agreements are common amongst insurance entities such that the entity can pool risks from its various insurance entities. Those arrangements are accounted for in stand-alone financial statements under current guidance and the staff notes that they should continue to be under the proposed guidance.

41. The staff notes that it would be difficult to exclude some intercompany insurance contracts from being accounted for while requiring other intercompany insurance contracts to be accounted for in an entity's stand-alone financial statements. In addition, the staff has not identified any other areas of U.S. GAAP that exempts an entity, in its stand-alone financial statements, from applying the accounting guidance to a transaction when it is amongst or between related parties. Finally, requiring an entity to reflect guarantees that meet the definition of insurance in its stand-alone financial statements would provide more transparency to the users of the financial statements, whether they be regulators, rating agencies, analysts, or investors.

Question 2: Guarantees amongst or on behalf of related entities
Does the Board agree that guarantees on behalf of or between related parties or entities under common control should be recorded in an entity's stand-alone financial statements?