

FASB Emerging Issues Task Force

Issue No. 08-5

Title: Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Guarantee

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Date previously discussed: None

Previously distributed EITF materials: None

References:

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

FASB Statement No. 157, *Fair Value Measurements* (FAS 157)

FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159)

Proposed FSP FAS 157-c, *Measuring Liabilities under FASB Statement No. 157* (proposed FSP FAS 157-c)

APB Opinion No. 21, *Interest on Receivables and Payables* (APB 21)

IASB Discussion Paper, *Reducing Complexity in Reporting Financial Instruments* (IASB Discussion Paper on Complexity)

*** The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

Statement 133 Implementation Issue No. B3, "Investor's Accounting for a Put or Call Option Attached to a Debt Instrument Contemporaneously with or Subsequent to Its Issuance" (DIG Issue B3)

Statement 133 Implementation Issue No. K3, "Determination of Whether Combinations of Options with the Same Terms Must Be Viewed as Separate Option Contracts or as a Single Forward Contract" (DIG Issue K3)

Background

1. Debt securities are often issued with a financial guarantee from an unrelated third party that guarantees the issuer's payment obligations. That guarantee is generally purchased by the issuer who then combines it with the debt and issues the combined security to an investor. By issuing debt combined with the guarantee, the issuer is able to obtain a lower interest rate and/or receive higher proceeds. For example, an entity with a B credit rating may be able to issue \$100 million in debt at 10 percent and receive \$80 million in proceeds. If the entity obtains a third-party guarantee from an entity with an AA rating, the issuer may be able raise \$100 million at an 8 percent interest rate. However, a portion of the \$20 million difference in proceeds is attributed to the fee paid to the guarantor for issuing the guarantee. The guarantee fee could be paid prior to the debt issuance, at the time of the debt issuance, or over the life of the liability. Generally, a guarantee is incorporated into the terms of the debt security and will transfer with the debt security.

2. The guarantee provides the investor with additional assurance that the obligation will be paid (either by the guarantor or the issuer). In most cases involving guaranteed debt, when the issuer defaults, it is not released from its obligation. The issuer is required to reimburse the guarantor. Therefore, from the issuer's perspective, upon default to the investor the issuer's obligation still exists, the only thing that has changed is the identity of the creditor.

3. Current accounting literature does not address whether the issuer should view guaranteed debt as one unit of accounting (the guaranteed liability) or two units of accounting (the unguaranteed debt and a third-party guarantee). In the past, the lack of guidance has not been a problem because accounting for the instrument as one unit of accounting or two units of accounting results in the same impact on the income statement each reporting period if it is measured in accordance with APB 21. To illustrate that point, assume that a reporting entity issues guaranteed debt with a par value of \$1,000 at 5 percent that matures in one year. The reporting entity would obtain a rate of 8 percent if it issued unguaranteed debt. For simplicity purposes, the cost of the guarantee in this example equals the coupon differential. Example A represents the accounting if the instrument is viewed as one unit of accounting and Example B represents the accounting if the instrument is viewed as two units of accounting.

Example A			Example B		
Upon issuance			Upon issuance		
DR	Cash	1000	DR	Cash	1000
CR	Payable to Guarantor	30	DR	Guarantee Asset	30
CR	Debt (guaranteed)	970	CR	Payable to Guarantor	30
			CR	Debt (unguaranteed)	1000
DR	Payable to Guarantor	30	DR	Payable to Guarantor	30
CR	Cash	30	CR	Cash	30
Subsequent accounting			Subsequent accounting		
DR	Discount Amortization	30	DR	Guarantee Amortization	30
CR	Debt	30	CR	Guarantee Asset	30
DR	Interest Expense	50	DR	Interest Expense	50
CR	Cash	50	CR	Cash	50
At maturity			At maturity		
DR	Debt	1000	DR	Debt	1000
CR	Cash	1000	CR	Cash	1000

4. In addition to the illustration above, there may be other ways in which entities account for guaranteed debt. The input received by the staff indicated that regardless of the method used to account for the guarantee, the impact on net income is generally the same.

5. FAS 159, which was effective fiscal years beginning after November 15, 2007, allows an entity to fair value its financial assets and liabilities subject to certain requirements. An entity has the option of electing the fair value option for the liability considered by this Issue. As a result, questions have arisen in practice regarding whether the issuer would consider the effect of the third-party guarantee when measuring the liability under FAS 157.

6. Paragraph 6 of FAS 157 states:

The unit of account determines what is being measured by reference to the level at which the asset or liability is aggregated (or disaggregated) for purposes

of applying other accounting pronouncements. The unit of account for the asset or liability should be determined in accordance with the provisions of other accounting pronouncements, except as provided in paragraph 27.

Therefore, in order to apply FAS 157, the issuer would need to identify the unit of accounting to determine what is being measured (guaranteed debt versus unguaranteed debt), which is discussed in this Issue Summary. This Issue does not address the unit of valuation under FAS 157, which may not be the same as the unit of accounting.

Scope

7. This Issue applies to all reporting entities that issue guaranteed debt (debt that is issued with a contractual third-party guarantee) that is measured at fair value. This Issue does not apply to guarantees provided by the government or government agencies, for example deposit insurance.

Accounting Issues and Alternatives

Issue: Whether an issuer of debt with a third-party guarantee that is inseparable from the debt instrument should treat the debt and the guarantee as one unit of accounting when the measurement attribute for that debt is fair value.

View A: An issuer of debt with a third-party guarantee that is inseparable from the debt instrument should treat the debt and the guarantee as one unit of accounting. This would require that an entity include the effect of a third-party guarantee in the fair value measurement of the liability.

8. Proponents of View A believe that the issuer's liability should be measured on the same basis as the investor's corresponding asset. That view is consistent with proposed FSP FAS 157-c, which requires that the liability's fair value be measured by reference to amounts in an active market for the corresponding asset. Opponents of View A argue that the guarantee does not provide the same economic results for the issuer and the investor; therefore, it is reasonable that the unit of accounting and fair value of the instrument will be different.

9. Additionally, paragraph 15 of FAS 157 states that "a fair value measurement assumes that the liability is transferred to a market participant at the measurement date (the liability to the counterparty continues; it is not settled) and that the nonperformance risk relating to that liability is the same before and after its transfer." Because the debt and guarantee are inseparable, proponents of View A believe that paragraph 15 would require the fair value measurement of the liability to include the effect of the guarantee.

10. View A proponents also believe that all credit enhancements, regardless of their form, should be treated consistently when determining fair value. Proponents argue that the guarantee is a form of credit enhancement that should be incorporated into the instrument's fair value similar to other credit enhancements that are linked to underlying obligations (for example, collateralized debt). Proponents believe that the guarantee impacts the terms of the debt (for example, the interest rate) in the same manner that posting collateral does, and, therefore, should be considered in determining fair value.

11. Opponents of View A refer to paragraph 15 of FAS 157, which clearly states that "the reporting entity shall consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value." They argue that View A would allow the reporting entity to measure the liability based on the guarantor's credit risk, which would provide counterintuitive economic results. For example, as the credit standing of the debt issuer declines, the fair value of the debt would be unaffected. Additionally, if the issuer defaults on the debt, a gain would be recognized because the guarantor would become the creditor to the issuer, but the debt would no longer be guaranteed (therefore, the debt would be measured using the issuer's credit risk).

View B: An issuer of debt with a third-party guarantee that is inseparable from the debt instrument should treat the debt and the guarantee as two units of accounting. This would require that an entity not include the effect of the third-party guarantee in the fair value of the measurement of the liability.

12. View B can be supported with two different bases. Under either basis, the fair value measurement of the debt would not consider the effect of the guarantee. Some proponents of View B believe that after the instrument is issued, the issuer has two units of accounting: unguaranteed debt and the third-party guarantee. Proponents believe that the issuer obtains an economic benefit resulting from the guarantee, but the benefit does not affect the measurement of the debt. Paragraph 15 of FAS 157 states that "the fair value of the liability shall reflect the nonperformance risk relating to that liability." Proponents of View B argue that the guarantee does not affect the issuer's likelihood of default. Therefore, it should not affect the nonperformance risk from the issuer's perspective.

13. Other proponents of View B believe that there are two units of accounting, but that one unit of accounting (the guarantee) is extinguished by the issuer when the debt is issued. In that case, the arrangement is viewed as two separate contracts. The debt is a contractual arrangement between the issuer and the investor; and the third-party guarantee is a contractual arrangement between the guarantor and the investor. The issuer purchased a guarantee on behalf of the investor and transferred the guarantee to the investor (extinguished it) at the same time it issued the debt to the investor. In other words, the issuer simply acted as an agent in the transaction between the investor and the guarantor. Proponents of this basis believe that the guarantee benefits the investor, that is, the investor will receive payment from the guarantor if the issuer defaults. The guarantee has no impact on the fair value of the debt because if default occurs, the liability is required to be paid to the guarantor instead of the investor. Proponents argue that if the only thing that changed upon default is the identity of the party to which the payment is owed, the measurement should not change. The liability to the guarantor would be measured based on the issuer's credit rating since the instrument is no longer guaranteed debt.

14. While FAS 133 includes a scope exception for financial guarantee contracts, proponents of View B state that some of the interpretations of that Statement provide analogous guidance for this Issue. For example, DIG Issue K-3 indicates that derivatives with separate counterparties are, for accounting purposes, typically considered separate units of accounting. Because they have different counterparties, the issuer's liability and the third-party guarantee may be considered two separate units of accounting. The guarantee is a contractual relationship that

obligates the third-party guarantor and benefits the investor, while the liability is a contractual relationship between the issuer and the investor. Furthermore, View B proponents highlight that DIG Issue B-3 counters the rationale used to support View A that the investor accounts for the combined contract as one unit of accounting. DIG Issue B-3 considers a call option issued contemporaneously with or subsequent to the issuance of debt. In that fact pattern, the Derivative Implementation Group concluded that a put or call option that is added to a debt instrument by a third party contemporaneously with or subsequent to the issuance of the debt instrument should be separately accounted for as a derivative under FAS 133 by the investor (that is, by the creditor). While in this case the guarantee is not added subsequently, the counterparty to the guarantee is a third party.

15. Opponents of View B note that if the only instrument the issuer has outstanding is unguaranteed debt and it is initially measured using the issuer's credit rating, the issuer may be required to report a day-one gain. That gain would represent the difference between the coupon differential (for example, AAA rating versus AA rating) and the premium paid to the guarantor to guarantee the debt. For example, if the reporting entity issues \$100 million of guaranteed debt for \$100 million in proceeds, a liability would be recorded for \$97 million (\$100 million principle, paid over 5 years, at an 8 percent unguaranteed debt rate). If the issuer purchased the guarantee for \$2.5 million, the issuer will record a \$0.5 million gain on day one.

View C: An issuer of debt with a third-party guarantee that is inseparable from the debt instrument should treat the debt and the guarantee as one unit of accounting. This would require that an entity include the effect of a third-party guarantee in the fair value measurement of the liability. Additionally, an issuer should record an asset upon issuance of the debt and reflect the changes in the issuer's credit rating by adjusting that asset.

16. Proponents of View C generally agree with View A, however, they believe that upon issuing the guaranteed debt (one unit of accounting), the issuer also records an asset, which represents a right for the guarantor to make a payment on the issuer's behalf upon default (similar to a put option on the debt to a third party). As the issuer's credit rating declines (the issuer's nonperformance risk increases), the value of the guarantee asset increases. For example, assume

a reporting entity issues \$100 million of guaranteed debt for proceeds of \$100 million with an interest rate of 5 percent. (The reporting entity could have issued unguaranteed debt of \$100 million and an interest rate of 8 percent and received \$97 million.) Upon issuance of the guaranteed debt, the issuer would record debt of \$100 million and a guarantee asset of \$3 million (amounts used for simplicity). If the issuer's credit rating falls such that the fair value of the unguaranteed debt is \$80, the issuer would increase the guarantee asset by \$17 million and record a gain. As a result, the sum of the guarantee asset (\$3 million + \$17 million = \$20 million) and the guaranteed debt (\$100 million) will equal the value of the unguaranteed debt. If the issuer were to default, the issuer would debit the guaranteed debt for \$100 million, credit the guarantee asset for \$20 million, and credit a payable to the guarantor of \$80 million (assuming the fair value was still \$80 million). Proponents of this view observe that it resolves any counterintuitive results that would result under View A.

17. As noted in paragraph 11 above, FAS 157 requires that a reporting entity consider its credit risk when valuing a liability each reporting period. Opponents argue that although this view may produce the same income statement results as View B, FAS 157 clearly states that the issuer's credit risk should be included in valuing the liability. This view requires the issuer to consider its credit rating in valuing an asset.

18. Opponents of this view believe that View C adds unnecessary complexity to the financial statements and would result in the same income statement impact as View B. They argue that if the objective is to present unguaranteed debt on the balance sheet and the changes in the issuer's credit rating in the income statement, then View B is easier to understand and apply.

International Convergence

19. The IASB discussed the measurement of guaranteed liabilities within its broad financial instruments project. That discussion did not address the unit of accounting issue that is described in this Issue. Paragraph B27 of the IASB Discussion Paper on Complexity states that "the tentative decision of the IASB is that if the guarantee is a contract between the guarantor and debt holder and does not affect the obligation of the debtor, the fair value of the liability is not affected by the guarantee." The IASB further concluded that a guarantee will only affect the fair

value of the obligation to the investor if the guarantor releases the issuer from its obligation. However, the IASB concluded that those situations would be rare. The FASB staff notes that this discussion paper includes views that have not been subject to the IASB's due process and may not reflect the ultimate view of the IASB that would be included in its final standard.

Disclosure

20. The staff considered requiring other disclosures and concluded not to recommend any incremental disclosure requirements beyond those already required by FAS 154, FAS 157, and FAS 159.

Transition and Effective Date

21. The staff has identified the following transition alternatives for Task Force consideration:

Alternative A: This Issue is effective for fiscal years beginning after December 15, 2008. Entities should recognize the effect of the change as a change in accounting principle through retrospective application to all prior periods for all arrangements that existed during the period of the financial statements presented. Entities should disclose the cumulative-effect of the change on retained earnings in the statement of financial position as of the beginning of the first period presented.

Alternative B: This Issue is effective for fiscal years beginning after December 15, 2008. Entities should recognize the effect of the change as a change in accounting principle as of the beginning of the fiscal year in which this consensus is initially applied for all arrangements existing at the effective date. The cumulative effect of the change in accounting principle shall be recognized as an adjustment to the opening balance of retained earnings for that fiscal year, presented separately.

Alternative C: Entities should recognize the effect of the change on a prospective basis beginning in the first reporting period after issuance of this EITF Issue. Early adoption is not permitted. The effect of initially applying the guidance in this EITF Issue shall be included in the change in fair value in the period of adoption.

22. Alternative A is consistent with paragraph 7 of FAS 154, which requires retrospective application to changes in accounting principles. Proponents of retrospective application refer to paragraph B7 of FAS 154, which specifies that "the Board concluded that retrospective application improves financial reporting because it enhances the consistency of financial information between periods. That improved consistency enhances the usefulness of the financial statements, especially by facilitating analysis and understanding of comparative accounting data." Alternative A would be the most costly to achieve from the preparer's perspective, but the comparability that would result provides the most benefit to the financial statement user. If the Task Force selects Alternative A, and depending on when a consensus in this Issue is ratified by the Board, it may need to reconsider the suggested effective date of fiscal years beginning after December 15, 2008.

23. Alternative B allows for the benefit of consistency and comparability for the current year and future years without the burden of recasting prior years' amounts. Alternative B requires entities to evaluate only the arrangements in effect at the effective date of this Issue. The staff acknowledges that with the reduced costs and burdens of Alternative B come less consistency and comparability for years prior to the year of adoption.

24. Alternative C would eliminate the need to reassess a significant number of transactions; however, it does not provide the comparability benefits that Alternative A does.