

FSR Insights

Financial Instruments, Structured Products & Real Estate Insights
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GASB issues final guidance on accounting on nonexchange financial guarantees

What's new?

On April 30, 2013, the Government Accounting Standards Board (GASB) published the final guidance on Accounting and Financial Reporting for Nonexchange Financial Guarantee Transactions in the form of GASB Statement No. 70 ("GASB No. 70").¹ GASB No. 70 requires state and local government and government agencies that provide nonexchange financial guarantees to recognize a liability when it is more likely than not that the guarantor will have to make payment.

The current economic environment has negatively affected the finances of many state and local government entities. The financial stress has led to the issuance or execution of various forms of financial guarantees.

In the previous issue of FSR Insights², we summarized the GASB's objectives, the main provisions of this standard, and comments received from its constituents. The GASB has reviewed the comments raised by the constituents, culminating in the issuance of GASB No. 70, which is effective for reporting periods beginning after June 15, 2013.

¹ GASB is the standard setting body for state and local governments. Standards for the US federal government are set by the Federal Accounting Standards Advisory Board (FASAB).

² <http://www.pwc.com/us/en/financial-instruments-and-credit/publications/gasb-nonexchange-financial-guarantees.jhtml>

Why now?

Many state and local government entities and related entities, including general purpose government and special-purpose government entities have issued or received nonexchange financial guarantees related to their debt issuances during the current budgetary and economic climate.

The GASB believes that a comprehensive standard is needed for the recognition and disclosure of financial guarantees that could lead to creditor claims. The disclosures will provide investors with information to better assess the probability that governments will repay the debt holders.

FSR Insight: *The GASB has added projects to its agenda in recent years to improve the transparency of the state and local government finances in response to investor and constituent concerns about financial resources and condition in the current budgetary and economic climate. These efforts have resulted in the GASB issuing several new standards including GASB No. 68, Accounting and Financial Reporting for Pensions and GASB No. 70.*

In July 2012, the US Securities and Exchange Commission issued a report³ discussing the current state of the municipal securities market and related recommendations.

³ US Securities and Exchange Commission, *Report on the Municipal Securities Market* (July 2012).

How does this impact me?

GASB No. 70 affects state and local governmental entities that provide and receive various forms of nonexchange financial guarantees – requiring financial statement preparers to:

- Identify and understand the terms and conditions of all nonexchange financial guarantees that are within the scope,
- Gather relevant historical and current data, and
- Develop cash flow models, and associated internal controls, to estimate the liabilities associated with the guarantees extended.

What are the main requirements?

GASB No. 70 addresses the recognition, measurement and disclosure of financial guarantees extended and received by an entity that does not directly involve receipt or payment of consideration of equal value in exchange (i.e., nonexchange transactions).

A nonexchange financial guarantee is defined as:

“a guarantee of an obligation of a legally separate entity that requires the guarantor to indemnify a third-party entity, the obligation holder, under specified conditions.”

FSR Insight: *The GASB decided to exclude from the scope financial guarantees in exchange and exchange-like transactions to focus on nonexchange financial guarantees that generally do not result in initial accounting transaction.*

The GASB clarified in GASB No. 70 that the moral obligations, joint and several obligations, and pledges of future revenues are excluded from its scope⁴.

Recognition

The recognition principle in GASB No. 70 is that a guarantor that extends a nonexchange financial guarantee recognizes a liability when qualitative factors indicate that it is more likely than not that it will make a payment on the guarantee.

The Summarized below are examples of qualitative factors mentioned in GASB No. 70:

- Bankruptcy or reorganization by the guaranteed entity,
- Breach of a debt covenant or terms or conditions related to a borrowing, such as a default or delinquency in interest or principal payments by the guaranteed entity,
- Indicators of significant financial difficulty, such as draw on reserve funds, concessions from debt holders, significant investment losses or loss of a major revenue source by the guaranteed party, or commencement of financial supervision by another government over the guaranteed party, among others.

In situations where a guarantor extends a similar guarantee to more than one party, relevant historical quantitative data for a group of similar guarantees should be considered when assessing whether that it is more likely than not that it will make a payment on a particular outstanding guarantee.

For instance, a guarantor may conclude that the probability of payment on any individual contract within a pool or group of similar guarantees is not more likely than not.

⁴ Governmental Accounting Standards Board of the Financial Accounting Foundation, Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, Appendix B, par. 30 (April 2013).

However, the guarantor may conclude, based on relevant historical data, that a payment on at least one of the guarantees in the pool is more likely than not. An example in GASB No. 70 is a guarantor's consideration of historical data that indicates 1 in 20 guarantees for a student loan program resulted in a guarantee payment.

The qualitative factors and historical data are used to assess whether it is more likely than not that an entity will make a payment on the guarantee.

A *more likely than not* criterion would require recognition of a liability in circumstances in which there is a greater than fifty percent (50%) probability that the guarantor will make a payment.

In the Basis for Conclusions and Dissent⁵, the GASB noted that “the conclusion that a future payment will more likely than not occur is a judgment based on facts and circumstances for each guarantee extended.”

FSR Insight: During the comment period, respondents raised concerns with the introduction of the *more likely than not* criterion.

The recognition threshold for loss contingencies under the scope of GASB Statement No. 62 is probable, which is defined as “the future event or events are likely to occur”⁶.

In retaining the more likely than not criterion in the GASB No. 70, the GASB concluded that a recognition principle should result in a more timely recognition of a liability from nonexchange financial guarantees.

⁵ Governmental Accounting Standards Board of the Financial Accounting Foundation, Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, Appendix B, par. 37 (April 2013).

⁶ Governmental Accounting Standards Board of the Financial Accounting Foundation, Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, par. 100 (December 2010).

The GASB was concerned many nonexchange financial guarantees were extended with an expectation that no payment would be made, and no liability was recognized at issuance even when it is evident that a liability has been incurred. As a result, financial statement preparers may need to develop or reassess their processes for recognizing liabilities for nonexchange financial guarantees to meet the requirements of GASB No. 70.

The recognition of a liability under the GASB No. 70 extends to arrangements whereby a government (guarantor) extends a nonexchange financial guarantee for an obligation of another government (issuer).

The issuer should recognize a receivable equal to the liability recognized by the guarantor when the issuer is (a) a blended component unit of the guarantor, (b) a primary government that includes the guarantor as a blended component unit within its reporting entity, or (c) within the same reporting entity and both the issuer and guarantor are blended component units of the same primary government.

FSR Insight: During the comment period, many respondents raised a concern that, for intra-entity guarantees, the financial statements for a reporting entity would recognize liabilities for the guarantor and the issuer – leading to “double-counting” when in fact, the liability would be paid only once by the reporting entity.

The GASB believes that the guaranteed party should not recognize a receivable from the guarantor for a guarantee payment prior to the guarantor making the payment.

The GASB concluded that for intra-entity guarantees, the guaranteed party should recognize a receivable in the amount of the liability recognized by the guarantor – allowing the receivable to be eliminated against the liability when the financial statements of the components are aggregated.

The guaranteed party in a nonexchange transaction is required to report the obligation until legally released as an obligor.

A guaranteed party that is required to repay a guarantor for making a payment on a guaranteed obligation or legally assuming the guaranteed obligation continues to recognize a liability to the guarantor until legally released, for example, when a Plan of Adjustment is confirmed by the court in a bankruptcy.

If a guaranteed party is legally released as an obligor for its own debt and for any liability to the guarantor, the issuer should recognize revenue for the reduction of its guaranteed liability.

Measurement

GASB No. 70 requires that a nonexchange financial guarantee liability be measured as “the discounted present value of the best estimate of the future outflows expected to be incurred as a result of the guarantee.”

If there is no best estimate but a range of estimated future outflows can be established, the liability would be measured as the minimum amount within the range.

The GASB clarified that this measurement approach is not a fair value measurement. The GASB concluded the best estimation approach is more appropriate given that guarantors generally do not sell or transfer such guarantees to third parties.

The measurement model in GASB No. 70 is consistent with GASB Statement No. 62, where a liability is measured using a

reasonably estimable amount that the entity expects to spend to settle the liability.⁷

The GASB No. 70 model differs from the expected cash flow approach in GASB Statement No. 49⁸ that is based on the sum of probability-weighted amounts from a range of possible estimated amounts.

FSR Insight: *The GASB decided not to provide further guidance as to the appropriate discount rate to be used in measuring the guarantee liability.*

During the comment period, some respondents suggested that the GASB include additional guidance and disclosures about the discount rate to be used.

Based on a wide range of institutions that apply GASB standards, and their varying credit standings, financial statement preparers need to evaluate, document and continuously monitor the appropriate discount rate to be used in measuring these liabilities.

Disclosures

Under GASB No. 70, both the guarantor and the issuer of guaranteed obligations need to provide new disclosures.

A guarantor will disclose information about the nonexchange guarantees by type of guarantee, regardless of the likelihood of payment, such as:

- The legal authority and limits for providing the guarantee and types of obligations guaranteed,
- Relationship to the guaranteed issuers,

⁷ As noted above, while the measurement approach in GASB No. 70 is the same as used in GASB Statement No. 62, the threshold for recognition is different.

⁸ Governmental Accounting Standards Board of the Financial Accounting Foundation, Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, par. 16 (November 2006).

- The term of the guarantee,
- The terms for recovering payments from the issuer, and
- The total amount of guarantees outstanding at the reporting date.

A guarantor that has recorded a liability or has made guarantee payments during the reporting period should disclose additional information such as:

- A description about the timing of recognition and measurement of guarantee liabilities,
- Changes in guarantee liabilities,
- Cumulative amount of indemnification payments made on guarantees outstanding at the reporting date, and
- Any expected recovery amounts on indemnification payments that have been made through the reporting date.

A guaranteed party at the reporting date should disclose, by type of guarantee, information such as:

- The name of the guarantor, along with the amount and term of the guarantee received,
- The current period and cumulative amounts of indemnification payments made by the guarantor, and
- A description of the requirements and the outstanding amount of any repayments to be made to the guarantor.

Similar disclosures are expected from a guaranteed party when indemnification payments have been made during the reporting period.

FSR Insight: During the comment period, some respondents have suggested that the GASB include a requirement to disclose the discount rate used to measure the liability.

The GASB decided not to specify quantitative or qualitative disclosures about specific assumptions used, including the discount rate used to measure the liability.

Transition and effective date

An entity would be required to apply the provisions of GASB No. 70 for reporting periods beginning on or after June 15, 2013. Early application is encouraged.

The provisions of GASB No. 70 are to be applied retrospectively, except that the cumulative amounts paid or received under a nonexchange financial guarantee may be disclosed prospectively.

Additional information

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