INTRODUCTION

The May 22, 2002 FASB Exposure Draft, Guarantor's Accounting and Disclosure Requirements, Including Indirect Guarantees of Indebtedness of Others (hereafter ED), addresses initial recognition, initial measurement, and disclosure issues related to guarantors. Although it undertook the guarantee project in conjunction with its project on consolidation guidance related to special-purpose entities (SPEs), the FASB addressed guarantees in a separate project because guarantees also arise in situations other than those associated with SPEs.

The ED calls for recognition and increased disclosure of the liability associated with a guarantor's obligations under guarantees. It takes the position that a guarantee obligates the guarantor in two respects: (1) the guarantor undertakes a noncontingent obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur and (2) the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur. The noncontingent obligation occurs when the guarantor commits to the guarantor, while the contingent obligation occurs only when certain future conditions arise; for example, the entity whose debt is guaranteed defaults on payments.

While the ED is not explicit on the nature of the noncontingent liability, we believe it is best characterized as deferred revenue for most guarantees. An example in the ED sets the stage for this interpretation: “if a seller-guarantor issues to its customer’s bank a guarantee of the customer’s loan whose proceeds are used to pay the seller for the assets being purchased, the failure to recognize a liability for the issuance of the guarantee overstates..."
Just as an insurer charges a premium as compensation for its exposure to losses, the guarantor in this example must be compensated for its guarantee commitment and resulting exposure under the guarantee—the noncontingent element. This example suggests that a portion of the proceeds from the sale be deferred, and recognized over the period of time covered by the guarantee.

The ED calls for the guarantor to recognize as a liability the fair value of the noncontingent element of the guarantee, and confirms the applicability of FASB Statement No. 5, Accounting for Contingencies, to the contingent element of the guarantee. The ED also identifies four disclosure items to be provided by the guarantor. These include:

- the nature of the guarantee, including how it arose and the circumstances that require the guarantor to perform under the guarantee,
- the maximum potential amount of (undiscounted) payments the guarantor could be required to make under the guarantee,
- the current carrying amount of the liability, and
- the nature of (1) any recourse provisions that enable the guarantor to recover from third parties any of the amounts paid under the guarantee, and (2) any assets held either as collateral or by third parties that the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee.

The ED raises issues related to valuation of contingent liabilities, financial statement recognition vs. footnote disclosure, and effects of increased footnote disclosure. This article examines academic research relevant to the issues raised in the ED and presents the views of the AAA Financial Accounting Standards Committee (FASC) (hereafter the Committee) on the ED. The Committee based these views on inferences from existing research findings, an understanding of the Conceptual Framework, and views expressed in previous Committees' communications with the FASB and IASC on guarantees related to transfers of financial assets and contingent liabilities.

**REVIEW OF RELATED ACADEMIC LITERATURE**

**Capital Markets (Archival) Research**

**Valuation Implications of Contingent Liabilities**

Capital markets research provides evidence that contingent liabilities are relevant to capital market participants' valuation decisions. For example, Banks and Kinney (1982) and Frost (1991) report negative market-adjusted stock returns for firms disclosing

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1 Lucent Technologies, Inc. disclosed transactions of this nature in its 2000 10-K: “As of September 30, 2000, Lucent had made commitments or entered into an agreement to extend credit to customers up to an aggregate of approximately $6.7 billion. As of September 30, 2000, approximately $1.3 billion had been advanced and was outstanding. In addition, as of September 30, 2000, Lucent had made commitments or entered into agreements to guarantee debt of customers up to an aggregate of approximately $1.4 billion, of which approximately $770 million was outstanding.”

2 There are instances in which companies charge explicitly for the noncontingent element of a guarantee. For example, in their 2001 annual report, La-Z-Boy, Inc. reports, “We have provided unsecured financial guarantees relating to loans and leases in connection with certain La-Z-Boy Furniture Galleries®. The guarantees require the dealers to make periodic payments to us in exchange for the guarantees. The guarantees have off-balance-sheet credit risk because only the periodic payments and any accrual for probable losses are recognized until a guarantee expires.”

3 Because the FASB restricted the scope of the ED to initial measurement of the guarantee liability, the ED provides no guidance on subsequent measurement of the noncontingent element of the liability.

4 These views can be found in AAA FASC (1998, 2002).
unexpected loss contingencies. Backmon and Vickrey (1997) find that reported loss contingencies influence the risk premia assessed on new bond issues. These findings suggest that market participants treat contingent obligations as liabilities when valuing firms, even when such obligations are not recognized on the face of the financial statements.

Capital markets research also demonstrates the value relevance of specific information related to contingent liabilities. Barth and McNichols (1994) find a negative correlation between firm value and estimates of unrecognized environmental liabilities based on information sources outside the firm's financial statements. Similarly, Hughes (2000) finds that nonfinancial measures of sulfur dioxide emissions are related to the market value of equity for electric utilities, and that this relation changes over time in response to changes in environmental regulation and utilities' production processes. Researchers report evidence that market prices incorporated estimates of post-employment benefit obligations prior to recognition of these obligations as liabilities (Amir 1993). Finally, Beaver et al. (1989) provide evidence that supplemental disclosures about characteristics of loan portfolios provide explanatory power for market-to-book ratios beyond information contained in the loan loss allowance recognized on the balance sheet. Overall, there is ample evidence that market participants use information disclosed in the footnotes and other sources to estimate the value implications of both contingent and noncontingent obligations.

**Implications of Enhanced Disclosure**

Capital markets research also offers evidence on the consequences to firms that provide enhanced disclosures. Although the notion that enhanced disclosure lowers a firm's cost of capital has been repeatedly proposed analytically for 20 years, empirical evidence on the impact of enhanced disclosure appears only recently. Botonis (1997) summarizes the theoretical literature and Leuz and Verrecchia (2000) review recent empirical literature on disclosure and the cost of capital. Other studies find additional consequences of increased disclosure. For example, Blaconniere and Patten (1994) and Blaconniere and Northcutt (1997) report that chemical firms with more extensive environmental disclosures suffer less negative market reactions in response to environmental disasters, such as the chemical leak in Bhopal, India, or environmental legislation events. Finally, Linsmeier et al. (2002) find decreased trading volume sensitivity to underlying market/price changes after disclosure of FRR No. 48 market risk information. Thus, research supports the idea that firms receive benefits from increased disclosure.

**Recognition vs. Disclosure**

Traditional capital markets research assumes that capital markets are efficient with respect to publicly available information, and tests for the value relevance of various types of public information. Research noted above indicates that footnote disclosures on contingent liabilities are value-relevant. Some empirical studies, however, relax the assumption of market efficiency and investigate whether market participants correctly impound footnote disclosures based on the expected price impact derived from models linking specific footnote information and stock price. Two studies conclude that prices partially ignore footnote disclosures on oil and gas reserves and pensions relative to the predicted implications of the models (Harris and Ohlson 1987; Landsman and Ohlson 1990). The results of these studies are difficult to interpret, however. Departures from predicted values may reflect
measurement error, investors who do not fully impound information due to processing biases or costs, or investors who discount the disclosed item in response to signals about the item's reliability inherent in recognition/disclosure rules.\(^5\)

**Experimental Research**

**Judgment Implications of Contingent Liabilities**

Experimental research also provides evidence that disclosures about contingent liabilities are useful to financial statement users. Kennedy et al. (1998) find that disclosure of the best estimate and other parameters of the distribution for an environmental liability reduces uncertainty and more closely aligns financial statement users' judgments with the actual amount and likelihood of the obligation. Results in Nelson and Kinney (1997) suggest that additional disclosures regarding uncertainty associated with a contingency help align auditors' and users' probability assessments with the realistic likelihood of the contingency.

**Recognition vs. Disclosure**

Experimental research suggests that the distinction between recognition and disclosure can affect the judgments and decisions of financial statement users. In a laboratory market experiment, Bloomfield and Libby (1996) find that prices respond only partially to information that is analogous to footnote information. Most studies examining judgments of individual financial statement users reach similar conclusions. For example, Sami and Schwartz (1992) report that bankers assess higher interest rates, lower maximum loans, and lower probabilities of repayment when pension liabilities are included in the balance sheet rather than disclosed in the footnotes. Other studies indicate that individuals do not adjust financial statement ratios for disclosures related to pensions and post-retirement benefits (Harper et al. 1987, 1991). However, Wilkins and Zimmer (1983) provide contradictory evidence that experienced financial statement users (bankers) incorporate disclosed information about leases into lending judgments, even though they do not explicitly adjust ratios for such liabilities. Recent research by Hirst et al. (forthcoming) indicates that the completeness of supplemental disclosures describing the effect of prior estimation errors on current-period results influences the extent to which individual investors incorporate the disclosures into their valuation-related judgments.

Experimental research also demonstrates that investors use financial statement classification and presentation format as a signal to the nature and importance of an item. Hopkins (1996) finds that financial analysts place higher values on a firm's common stock when mandatorily redeemable preferred stock is classified as shareholders' equity rather than as a liability. Maines and McDaniel (2000) document that presenting unrealized gains and losses on marketable securities in a performance statement vs. a statement of stockholders' equity influences individual investors' perceptions of the importance of those unrealized gains and losses to firm performance.

Finally, experimental research suggests that less knowledgeable investors are more likely to be affected by the placement of financial information than more knowledgeable investors such as analysts. First, less knowledgeable investors' lack of understanding about the importance of various financial data for investment purposes leads them

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\(^5\) See Bloomfield (2002) for further discussion on the effect of costs of extracting data from publicly available sources on the market's ability to impound this information into prices.
to read financial statements sequentially (Bouwman et al. 1987; Hunton and McEwen 1997). Since footnotes typically appear after the financial statements, less knowledgeable investors may ignore footnotes due to information overload, or place less weight on this information. Second, less knowledgeable investors rely on the financial statements to signal the importance of information and may infer that information placed in footnotes is less important for evaluating firm performance than information reported in the financial statements.

Overall, experimental research supports the value-relevance of information related to contingent liabilities such as guarantees, but suggests that recognition vs. disclosure of such information makes a difference. Factors such as cognitive processing costs and investors' use of disclosure as a signal about the nature and importance of information appear to reduce the impact of disclosed information compared to recognized information. These findings provide a possible explanation for archival studies that find the stock market incompletely processes footnote information.

**COMMITTEE VIEWS ON THE FASB ED**

The Committee strongly supports the disclosure requirements of the ED. Research consistently documents that disclosure of information about contingent liabilities (both the noncontingent and contingent elements) is relevant in capital market valuation decisions. Prior research indicates that relevant information includes a description of the nature and uncertainty of the obligation, critical components of the estimate of the obligation, and other relevant facts needed to assess the likelihood and magnitude of the obligation. This research clearly supports the importance of disclosed information about guarantees.

With respect to recognition of the noncontingent element of the guarantee, academic research provides mixed evidence on the need for recognition. Some academic research using archival stock price data finds that the capital markets treat items that are currently considered contingent liabilities as obligations even when they are not formally recognized in the body of the financial statements. Such research suggests that recognition of the noncontingent element of guarantees is not needed as long as there is sufficient disclosure related to the guarantee. In contrast, other archival and experimental research indicates that disclosed information is not fully incorporated into financial statement users’ judgments and decisions. Additionally, this research suggests that some financial users rely on classifications in the financial statements, such as the liability classification, to signal the nature of a transaction. Such users may not interpret disclosed information on guarantees as signaling a liability. Overall, research suggests that recognition is not always necessary for the financial statements to provide useful information to investors, but that it is beneficial for financial statement users in some circumstances.

In responding to the issue of whether guarantees should be recognized under the Conceptual Framework, the Committee classified guarantees into two categories: (1) those associated with a related transaction, such as a sale to a customer and a subsequent guarantee of a loan from a third party to the customer, and (2) those not associated with a specific transaction.

**Guarantees Associated with Specific Transactions**

The Committee views this type of guarantee as an example of a deferred revenue and agrees with the reasoning of the Board that a guarantor’s failure to recognize a liability for a guarantee issued without a separately identifiable premium will cause
the guarantor’s periodic gain or loss to be misstated. The Committee also agrees with the use of fair value to measure the noncontingent element of guarantee, consistent with the Committee’s prior views on guarantees related to transfers of financial instruments that are accounted for as sales.

With respect to subsequent accounting for the liability, the Committee views the guarantee as a form of insurance. The Committee recommends that the ED require that the noncontingent part of the guarantee be accounted for as a short-duration insurance premium, recognized as revenue by the guarantor over the period of the contract in proportion to the amount of insurance protection provided. This is the accounting prescribed in FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises. The Committee also notes that Emerging Issues Task Force 85-20, and Securities and Exchange Commission Staff Accounting Bulletin 60 require that fees for loan guarantees be recognized in income over the period of the guarantee. We see no reason to permit different accounting for a guarantee simply because the premium is not separately identified. To permit other accounting treatments would honor the form over the substance of the transaction.

Related to this point, the Committee is concerned about restricting the ED to guarantees because some transactions explicitly excluded in the ED, such as warranties, have similar economic properties to guarantees. The Committee believes the ED will result in economically similar transactions receiving different accounting treatment.

Finally, recognition is consistent with SFAC No. 5, para. 84(a), (b), and (d), which states “Revenue should not be recognized until the seller has substantially accomplished what it must do pursuant to the terms of the arrangement, which usually occurs upon delivery or performance of the services.” In the case in which consideration is received at the inception of the guarantee, that portion of the consideration that relates to the guarantee should not be recognized until the service is performed. The fact that the consideration is not separately identifiable does not justify violation of revenue recognition principles.

Guarantees Not Associated with Specific Transactions

With respect to the second category of guarantees—those not associated with a specific transaction—the Committee is divided in its opinion. Some Committee members believe such a guarantee does not meet the definition of a liability in SFAC No. 6. Accordingly, those members disagree with the ED’s proposal to recognize a liability for the noncontingent portion. Other members believe the guarantor will issue a guarantee only if it is economically rewarding to do so, that is, the guarantee is made in expectation of future benefits related to the party currently benefiting from the guarantee. Assuming a future relation is expected to exist between the guarantor and this party, these Committee members agree with the ED’s proposal to recognize a liability for the noncontingent portion of the guarantee.

Finally, for both of these two guarantee categories, the Committee supports the ED’s recommendation that the contingent element of the guarantee continue to be accounted for in accordance with FASB Statement No. 5. As noted, empirical research supports the position that disclosure of unexpected loss contingencies is relevant to capital market participants.

SUMMARY

Overall, the Committee believes that the ED’s proposal for increased disclosure about guarantees will benefit users of financial statements by illuminating commitments made by companies and the associated risks of those commitments. Additionally, the Committee supports recognizing the fair value of the guarantee commitment—the
noncontingent element—as a liability in the financial statements for guarantees associated with specific transactions. In this case, the Committee believes that a guarantee represents deferred revenue and should be accounted for as such. Accordingly, the Committee also encourages the FASB to include in the ED guidance on the accounting for this liability subsequent to its initial recognition, and recommends that this guidance take the form of accounting for deferred revenue such as that for insurance premiums. In the case where a guarantee is not associated with a specific transaction, the Committee believes that, at a minimum, more information about the terms and associated contingencies of the guarantee be disclosed in the footnotes.

REFERENCES


