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July 10, 2002

Suzanne Q. Bielstein, CPA
Director, Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116
e-mail: director@fasb.org

Dear Ms. Bielstein:

Re: Exposure Draft of a Proposed Interpretation,
Guarantor's Accounting and Disclosure Requirements
for Guarantees, Including Indirect Guarantees of
***Indebtedness of Others* - File Reference 1124-001.T**

The New York State Society of Certified Public Accountants, the oldest state accounting association, which represents some 30,000 CPAs, thanks the FASB for the opportunity to comment on the above-referenced Exposure Draft.

The Society's Financial Accounting Standards Committee deliberated the provisions contained in the Exposure Draft and prepared the attached comments for the Board's consideration. If the FASB would like to discuss these comments with the Committee, please contact Steven Rubin, the Committee chair, at (212) 492-3799, or Robert Colson, NYSSCPA staff, at (212) 719-8350.

Sincerely,

Jo Ann Golden
President

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**NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

COMMENTS ON FASB EXPOSURE DRAFT

Proposed Interpretation,
Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others **- File Reference 1124-001.T**

Principal Drafter

Steven Rubin

June 11, 2002

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The New York State Society of Certified Public Accountants
Financial Accounting Standards Committee
Comment Letter

Exposure Draft (ED) of a Proposed Interpretation,
Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others **- File Reference 1124-001.T**

June 20, 2002

General Comments

Opposition to ED

We do not support the issuance of the Interpretation, as substantially proposed, for the following reasons.

Recognition and Measurement. Consistent with the two Board members whose alternative views are expressed in paragraph A31 of the ED, we:

- Believe the proposed recognition and measurement issues addressed in the ED are extraneous to current user concerns.

- Believe the proposed recognition and measurement requirements do not include sufficient guidance on the initial and subsequent-period accounting issues.

- Would like to see recognition and measurement issues addressed in a more comprehensive project.

- Question whether the benefits to be derived from the proposed recognition and measurement requirements justify the cost of their implementation.

Disclosures. We support the Board's desire for enhanced disclosures for obligations under guarantees, but would like to see such disclosures addressed in a more comprehensive project that would include field-testing.

As between disclosure issues, on the one hand, and recognition and measurement issues, on the other, we believe that the disclosure issues are more important, and we strongly encourage the Board to resolve the disclosure issues immediately and to spend additional effort on the recognition and measurement issues.

Comment Period

We are dismayed that the Board chose such a relatively brief comment period to elicit views on a proposal that represents a major change to the accounting literature (SFAS No. 5, *Accounting for Contingencies*), which, in turn, is expected to lead to a major change in practice for a relatively large number of companies.

Standard Instead of Interpretation

We do not agree with the Board's conclusion in A28 of the ED that an Interpretation, rather than a Standard, is the appropriate type of pronouncement for the recognition and measurement requirements being proposed.

There is a general understanding that the stated purpose of an Interpretation is to clarify or elaborate on an accounting requirement contained in an existing Standard, while the stated purpose of a Standard is to create a new accounting requirement or to change an accounting requirement contained in an existing Standard.

Based on that general understanding, we observe that this ED clearly changes an accounting requirement (the timing of liability recognition) in an existing Standard (SFAS 5) and, therefore, we conclude that the ED should result in a Standard, not an Interpretation.

Specific Comments

If the Board decides to proceed with the issuance of a final pronouncement, whether in the form of a Standard or Interpretation, we have the following comments.

Recognition of Liabilities

We believe the ED's proposed requirements for recognition of a liability for an obligation under a guarantee do not meet the recognition criteria for a liability set forth in the FASB's conceptual framework.

Specifically, paragraph 63 of Statement of Financial Accounting Concepts (SFAC) No. 5, "Recognition and Measurement in Financial Statements," states that:

> An item and information about it should meet four fundamental recognition criteria to be recognized and should be recognized when the criteria are met, subject to a cost-benefit constraint and a materiality threshold. Those criteria are:
>
> *Definition*—The item meets the definition of an element of financial statements.
>
> *Measurability*—It has a relevant attribute measurable with sufficient reliability.

> *Relevance*—The information about it is capable of making a difference in user decisions.
>
> *Reliability*—The information is representationally faithful, verifiable, and neutral.

It is our position that a guarantor should not recognize an obligation under a guarantee as a liability in its financial statements until the obligation actually meets those four criteria for recognition as a liability.

As to each of those four criteria, we provide the following additional commentary.

Definition. Paragraph 35 of SFAC No. 6, "Elements of Financial Statements," defines liabilities as

> Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

Accordingly, we believe an obligation under a guarantee cannot qualify for recognition as a liability until it becomes probable that the guarantor will be called on to make payments.

In further support of this view, we refer to paragraphs 204 and 205 of SFAC 6, which discuss obligations under guarantees and the guarantor's need to assess the probability of having to pay such an obligation in order to determine whether it has a liability to recognize:

> 204. Most liabilities are obligations of only one entity at a time. Some liabilities are shared—for example, two or more entities may be "jointly and severally liable" for a debt or for the unsatisfied liabilities of a partnership. But most liabilities bind a single entity, and those that bind two or more entities are commonly ranked rather than shared. For example, a primary debtor and a guarantor may both be obligated for a debt, but they do not have the same obligation—the guarantor must pay only if the primary debtor defaults and thus has a contingent or secondary obligation, which ranks lower than that of the primary debtor.
>
> 205. Secondary, and perhaps even lower ranked, obligations may qualify as liabilities under the definition in paragraph 35, but recognition considerations are highly significant in deciding whether they should formally be included in financial statements because of the effects of uncertainty (paragraphs 44-48). For example, the probability that a secondary or lower ranked

obligation will actually have to be paid must be assessed to apply the definition.

Measurability. The ED has not persuaded us that the fair value of an obligation under a guarantee can be determined with sufficient reliability to qualify for recognition as a liability.

Relevance. For the reasons set forth in the alternative views expressed in paragraphs A32 and A33 of the ED, we do not believe that recording a liability in the financial statements for an obligation under a guarantee meets the threshold of being capable of making a difference in user decisions.

Reliability. The absence from the ED of sufficient, clear, and unequivocal guidance on when an obligation under a guarantee should be recognized as a liability and how it should be measured raises serious concerns as to whether a resulting liability can be considered representationally faithful, verifiable, or neutral.

Better Guidance Needed

Notwithstanding the above, any final pronouncement should provide sufficient, clear and unequivocal guidance on both the initial and subsequent-period accounting for an obligation under a guarantee, particularly for obligations under related-party guarantees. Such guidance should address not only recognition and measurement issues, but also issues relating to financial statement display, including the "debit side" of the transactions that would cause liabilities to be recorded.

The following are examples of issues for which we believe sufficient, clear, and unequivocal guidance is not provided in the ED, but ought to be in any final pronouncement:

- Assume a guarantor somehow determines, using the guidance in SFAC No. 7, that there is a 10 percent chance that it will have to pay another entity's entire $10 million bank loan. Should the guarantor record a liability for (a) $1 million, (b) zero, based on the overwhelming 90 percent chance that it would not have to pay anything at all, or (c) some other amount?

- How would accountants verify the amount to be recognized?

- How could a guarantor use, as the fair value of an obligation under a guarantee, the amount it would have to pay an unrelated third party to assume its obligation if there is no third party willing to assume that obligation?

- Assume two companies have jointly and severally agreed to guarantee a third company's $10 million bank loan. Does each guarantor recognize a liability for (a) $10 million, (b) $5 million, or (c) some other amount?

- How are the recognition and measurement provisions of the ED intended to apply to consolidated or combined financial statements when, for example

    1. cross-collateralization agreements exist between subsidiaries or commonly-controlled entities or

    2. a subsidiary has guaranteed its parent company's $10 million bank loan. Should the consolidated financial statements reflect twice the $10 million, or $20 million, in liabilities relating to the same $10 million loan?

- Stockholders that are officers of small and medium sized companies are often required to provide personal guarantees in order for their companies to obtain financing. Are the recognition and measurement provisions of the ED intended to apply to personal financial statements?

<u>Other Comments</u>

Certain passages in the ED are long and ambiguous and, in some cases, incomprehensible. The following are examples of passages in the ED that we believe need to be reworked before any final pronouncement is issued:

- <u>Paragraph 8</u> - The definition of a *noncontingent* component of a guarantee is virtually indistinguishable from the *contingent* component. The stated difference is that the *noncontingent* element pertains to the guarantor *performing* its obligation, while the *contingent* element pertains to the guarantor *paying* its obligation. It would seem that the guarantor ordinarily *performs* on the obligation by *paying* the obligation.

- <u>Paragraph A9c</u> lists one of three types of guarantee contracts excluded from the initial recognition and measurement provisions of the proposed Interpretation. The wording of that sub-paragraph, which reads as follows, could certainly be improved:

    > A guarantee by an original lessee that has become secondarily liable under a new lease that had relieved the original lessee from being primarily liable for the lease payments under the original lease, as discussed in paragraphs 38(a) and 38(c) of Statement 13, as amended by Statement 145.