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September 27, 2012

Mr. David R. Bean  
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Project No. 19-18  
Governmental Accounting Standards Board  
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Dear Mr. Bean:

The American Institute of Certified Public Accountants (AICPA) has reviewed the Governmental Accounting Standards Board (GASB) Exposure Draft (ED), *Accounting and Financial Reporting for Nonexchange Financial Guarantee Transactions*, and is pleased to offer its comments. While we support some of the concepts proposed in the ED, we do have several significant comments and recommendations relating to the scope of the ED; the introduction of the “more likely than not” approach to accruing a liability; and the discount rate; which are detailed in the following section of this letter. The final section of this letter includes our other comments and recommendations.

## **SIGNIFICANT COMMENTS AND RECOMMENDATIONS**

### ***Definition of Financial Guarantees Needs More Clarity***

We believe that the ED does not adequately define a financial guarantee. Paragraph 4 defines a nonexchange financial guarantee 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. While paragraphs 23-25 of the Basis for Conclusions address the Board’s rationale regarding the separate entity concept as used in the definition (i.e., holder, issuer, and grantor), the Basis for Conclusions does not address the types of financial instruments that might be considered guarantees. For example, all of the illustrations provided in Appendix C of the ED refer to traditional debt issuances. We question whether other types of transactions such as derivatives, payables, third-party pledges of revenue, or letters of credit should also be considered financial guarantees. Additionally, we question whether performance obligations or other obligations that are not currently recorded by the entity issuing the guarantee should also be considered. To ensure consistency in the implementation of the final Statement, we recommend the Board specifically expand the definition in paragraph 4 or enhance the Basis for Conclusions to address the types of financial instruments or contracts that would be included in the scope of the Statement or include examples other than bond issuances in Appendix C. Taking such action would vastly improve the understanding of what should be regarded as a financial guarantee.

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***Scope of the Exposure Draft Excludes Exchange Transactions and Uncertainty around Whether Certain Transactions Are Within Scope***

With regard to the scope of the ED, we have two concerns. First, we are concerned that the Board did not include financial guarantees that are exchange transactions in the scope of this ED. We understand from the discussion in paragraph 26 that the Board believes financial guarantees that are exchange transactions would be more appropriately addressed in reexamination projects related to the various types of exchange transactions associated with an extended guarantee. Given the prevalence of financing authorities, which routinely enter into arrangements provided with guarantees as part of fee transactions, we urge the Board to make it a priority to consider the accounting and financial reporting for these types of exchange transactions in the future. Second, it is unclear whether certain transactions would fall within the scope of the ED. For example, financing authorities sometimes provide financial guarantees without charging fees that are commensurate with the fair value of the guarantees. One specific example is as follows:

ABC Finance Authority acts as a guarantor of a bond issue to make the bonds marketable to bond buyers nationwide. The guarantee provides the necessary credit enhancement for the bondholder and takes the place of a line of credit or bond insurance. ABC Finance Authority charges a onetime flat guarantee fee of 5% of the principal amount of the bond issue.

We believe it will be difficult to determine whether an arrangement like the example above should be classified as an exchange transaction, and not subject to this ED's guidance, or as a nonexchange transaction, and within the scope of the ED. Depending on the credit strength of the issuer in the example provided, the 5% fee may or may not be commensurate with what a nongovernmental financial institution would charge for a similar guarantee (which would typically be determined based on the risk the institution would be undertaking). We recommend that to ensure consistency in practice that the Board provides additional guidance to assist preparers in appropriately determining whether these types of guarantees would be subject to the ED. For example, the Board could provide a listing of indicators to the final standard for the purpose of guiding preparers through determining whether such transactions would be included in the scope of this standard. Another alternative would be to provide more explicit guidance, such as a defined test, that would be used by preparers to determine whether such transactions would be within the scope of the ED.

***Introducing "More Likely than Not" Causes Consistency Concerns***

We are concerned about the lack of consistency and potential confusion that will result by the introduction of the "more likely than not" criteria in this standard. Traditionally, GASB has used the "probable" criteria for other types of similar contingent liabilities. The end result of introducing the "more likely than not" criteria will be that financial statement users looking down the column of liabilities in the balance sheet may not be aware that differing criteria have been used to determine various liability amounts. As a result of this concern, we support the Alternative View stated in the ED which advocates that the same "probable" contingent liability recognition as other nonexchange and exchange

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transactions under paragraphs 100-105 of GASB Statement 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. Consistent with the Alternative View, we were also not convinced by the discussion in paragraphs 28 and 29 of the Basis for Conclusions as to why these financial guarantees are so unique to be treated differently from the “probable” concept used for other contingent liabilities.

If the Board moves forward with the “more likely than not” recognition point, we recommend the Board reconsider requiring an expected cash flow approach to estimating the liability. Paragraph 34 of the Basis for Conclusions states that the cash flow approach was discarded because the Board was concerned that it would not result in a faithful presentation of the guaranteeing government’s liability in situations in which the likelihood of payment is 50 percent or less. However, we believe the Board’s recommended approach in paragraph 9 also presents challenges. It requires using a best estimate or, if there is no best estimate but a range in which no amount appears to be a better estimate than any other amount within the range, the minimum amount in that range should be recognized. If a preparer asserts that there is no best estimate and the minimum in a range is zero, the result could be that no accrued liability would be recognized. When no amount within the range would be a better estimate than any other amount of payments in relation to a single guarantee, the expected cash flow approach would at least result in the median of the range being recorded. In our view this would be more representative of the amount of the liability than the minimum.

***Broad Discount Rate Guidance Would Encourage Consistency in Practice***

Paragraph 9 requires the guarantor to recognize a liability and an expense in financial statements prepared using the economic resources measurement focus using the best estimate of the discounted present value of the future outflows expected to be incurred as a result of the guarantee. While we agree with the use of a discounted rate, we have concerns that without more specific guidance relating to how to develop the discount rate, there will be inconsistency in practice. For example, GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, requires the application of a discount rate but does not provide guidance on how to develop the rate. As a result, we have observed a disparity in practice as it relates to the discount rate being used. We recommend that the GASB develop broad guidance that would describe for preparers how to develop a discount rate. This guidance should be made applicable to the various standards for which GASB requires the application of a discount rate (excluding the pension standards which include specific discount rate requirements). Such guidance would go a long way to promoting consistency in practice. If it is not possible in the near term for the Board to provide broad guidance in this area, we suggest, at a minimum, the Board provide more detailed guidance within this standard on how to develop the discount rate relating to financial guarantees.

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***Clarification on the Measurement Focus for Governments Receiving a Financial Guarantee Needed***

Paragraphs 9 and 10 provide guidance for both the economic resources and current financial resources measurement focuses for governments extending financial guarantees. While paragraphs 11 and 12 discuss the accounting treatment for the guaranteed obligation when a government is required to repay a guarantor for payments made on the government's obligations, we question whether a liability would be recorded when due or if past due as the guidance provided did not specify the measurement focus. Thus, we ask the Board to provide additional measurement focus clarification.

***Treatment of Financial Guarantees that May Not be Recorded***

With regard to the accounting for governments receiving a financial guarantee discussed in paragraph 11, we question whether there could be a situation in which there is an obligation subject to the guarantee that would not be recorded as a liability by the government receiving the guarantee. For example, we considered whether a long-term purchase commitment or letter of credit could be the objective of a financial guarantee. If so, then the accounting treatment proposed in paragraph 11 is unclear because there would be no liability to offset. We encourage the Board to consider financial guarantees that may be an unrecorded liability in the final Statement and provide guidance on how to treat such a transaction.

**OTHER COMMENTS AND RECOMMENDATIONS**

***Recognition and Measurement of Financial Guarantees – Consideration of Similar Guarantees to a Group***

Paragraph 8 states, "When a government extends similar guarantees to a group, the government should consider applicable qualitative factors in relation to the issues in the group or should consider relevant historical data to assess the likelihood that the government will make a payment in relation to those guarantees." We question whether it is the Board's intent that a guarantor would consider either qualitative factors or relevant historical data or both. We believe the "or" in the sentence referred to above should be changed to "and" since both assessments would seem to apply to a government issuing similar guarantees to a group. If that is not the Board's intent, we suggest adding more discussion in the Basis for Conclusions to clarify this point.

***Expansion of Appendix C, Illustrations***

Paragraph 25 of the Basis for Conclusions clarified that for purposes of this Statement, both blended and discretely presented component units should be considered separate entities. In order to provide comprehensive examples of the accounting and reporting for these nonexchange transactions, we ask the Board to consider adding additional illustrative examples covering both discrete and blended component unit presentation when financial guarantees are entered into with the primary government. We are especially interested in the presentation for blended component units to understand whether there would be a due to and due from or eliminating entries related to a financial guarantee with the primary government. Finally, we would like the Board to provide a more detailed explanation and

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computation for the increases in the liability recognized for the nonexchange financial guarantee shown in the illustrative disclosures.

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The AICPA appreciates the opportunity to comment on the ED. This comment letter was prepared by members of the AICPA's State and Local Government Expert Panel and was reviewed by representatives of the Financial Reporting Executive Committee who did not object to its issuance. Representatives of the AICPA would be pleased to discuss these comments with you at your convenience.

Sincerely,



James C. Lanzarotta  
Chair  
AICPA State and Local Government  
Expert Panel



Mary M. Foelster  
Director  
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cc: State and Local Government Expert Panel  
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