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October 12, 2012

David R. Bean, CPA
Director of Research and Technical Activities
GASB
401 Merritt 7
PO Box 5116
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Re: June 18, 2012 Exposure Draft (ED) of a Proposed Statement of the Governmental Accounting Standards Board, *Accounting and Financial Reporting for Nonexchange Financial Guarantee Transactions* [Project No. 19-18]

Dear Mr. Bean:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to represent the views of local and regional firms on professional issues in keeping with the public interest, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC appreciated the opportunity to discuss its comments on this ED with the GASB Chair and staff at the GASB/TIC Liaison Meeting on September 24, 2012. TIC has re-examined the ED and is providing the following comments for your consideration.

GENERAL COMMENTS

TIC supports the Board's efforts to develop recognition and measurement criteria for state and local governments that have extended or received financial guarantees through nonexchange transactions. However, TIC supports the Alternative View for recognition of financial guarantee liabilities for nonexchange transactions. TIC is also seeking clarification on a number of points, including the scope of the proposed standard, the need for periodic reassessment of the recognition and measurement criteria and accounting for recoveries. TIC has also made several suggestions to enhance the usefulness of the implementation guidance. TIC's detailed comments on the above issues are presented below.

SPECIFIC COMMENTS

Recognition Threshold in Economic Resources Financial Statements

The ED has adopted a “more likely than not” (MLTN) threshold for the recognition of a liability in economic resources financial statements attributable to nonexchange financial guarantees that have been extended by a government. The ED defines MLTN as a likelihood of more than 50 percent.

TIC believes adoption of an MLTN recognition threshold for this standard would be problematic for a number of reasons. MLTN is a term that is not officially defined in the GASB literature (prior to this ED) and has rarely appeared in the standards. TIC was able to find only one other instance of the term in the Basis for Conclusions of GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, where the context was “probable terms of expected transactions.” Paragraph 121 of the Standard compared MLTN to “probable” saying that “probable” means “likely to occur” and would require a greater likelihood of occurrence than MLTN.

However, the context of this ED is not an expected transaction. Rather, a guarantee of indebtedness of others is a type of contingency per GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, paragraph 98b. In GASB Statement No. 62, the terms used to describe the likelihood that future events will confirm the potential guarantee obligation are “probable,” “reasonably possible” and “remote” (paragraph 100). Most state and local governments will not understand the concept of MLTN, since it has not been previously used in the context of contingencies. Governments are unlikely to be able to conceptualize situations where the need to honor the guarantee would be more likely than “reasonably possible” but less than “probable.” Consequently, they are unlikely to understand how to draw the line between probable and MLTN.

GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, also introduces a recognition threshold below “probable” but includes guidance in the form of “obligating events” that help constituents determine when one or more components of a pollution remediation obligation should be recognized as a liability. Such guidance is absent from this ED. The existence of the various thresholds in GASBS No. 62, GASBS No. 49 and this proposed standard will create confusion and diversity in practice.

TIC is also concerned that a “less than probable” threshold for recognition of a guarantee liability will add estimated liabilities to the balance sheet that will never lead to actual cash outflows. Premature accruals and their subsequent reversal when the relevant cash outflows do not come to pass add complexity to the financial statements. In summary, TIC agrees with the Alternative View (paragraph 54) on this point.

Apart from the confusion and diversity in practice that the proposed recognition threshold would cause, TIC is also concerned about introducing a new term in the GASB literature without proper due process as to its application to other contingencies and the definition of a liability. Although the concept has roots in the authoritative literature of the FASB and the Federal Accounting Standards Advisory Board, TIC believes an arbitrary change to one particular GASB standard is not an appropriate method of convergence and

sets a bad precedent. The proposed change is significant enough to warrant a separate project with a wider scope. If, after due process, the MLTN threshold is deemed to be a better alternative, then all relevant standards could be changed at once.

TIC therefore recommends retention of the “probable” recognition threshold for this proposed standard. This term reflects TIC’s view that a liability should not be recognized until the government is almost certain that it will have to honor the guarantee.

If the Board has identified inconsistencies in current practice with respect to the accrual of a guarantee liability, TIC believes a better solution is to provide examples of events or qualitative factors that would indicate it is “probable” that the government would have to honor its guarantee. Although the examples could not be all inclusive, they should serve to improve current practice. This approach is more likely to mitigate the problems encountered compared to the establishment of a new threshold, which would have its own implementation issues. Another option would be to enhance the disclosure requirements for guarantees (beyond those already required in GASBS No. 62, paragraph 109, and this ED) to provide an early warning of potential problems, assuming such information is available.

Definition of Financial Obligations

The Basis for Conclusions of the ED states that a financial guarantee should require a guarantor to perform an action under specified conditions. TIC was uncertain how to apply that statement to guarantees based on performance obligations. For example, an urban renewal agency works with local contractors to re-develop the downtown area of a municipality. The agency may have a performance obligation to arrange and pay for construction to be completed if the original contractor is unable to finish the job. TIC was uncertain whether this example would represent a type of financial guarantee or financial obligation that would be recognized as a liability when the recognition threshold is met.

TIC recommends additional guidance to clarify the applicability of the final standard. Since the stated scope is limited to nonexchange guarantees, additional guidance should clarify whether such guarantees would be limited to those governed by legislative or contractual requirements (or both), as discussed in GASB Concepts Statement No. 4, *Elements of Financial Statements*, paragraph 56, or would include constructive or performance obligations, such as the urban renewal agency example above. Such guarantees may not have been extended up front and may arise only when a triggering event occurs. In the case of guarantees involving component units that are separate legal entities, it would be helpful to know if all of the conditions in paragraph 4.22.4 of the *Comprehensive Implementation Guide (Updated through June, 30, 2011)* would also qualify as a financial obligation that falls within the scope of the ED. For example, there may be a contract in place with a component unit that authorizes (but does not require) the primary government to consider honoring a guarantee on behalf of another entity.

Another issue involves guarantees extended by a government in exchange for a minor fee received. If the fee is minor compared to typical fees received in an exchange transaction,

TIC was uncertain whether such transactions would fall within the scope of the ED. GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, paragraph 7, implies that guarantees extended in exchange for minor fees received could be defined as nonexchange transactions if the benefit given to the party receiving the guarantee is of greater value than the fees received. TIC suggests the final standard clarify whether fees received of an incidental nature in connection with a guarantee would be classified as a nonexchange transaction. Guidance would also be needed on how to assess the size of the fee.

Reassessment of Nonexchange Guarantees

The disclosure requirements in the ED imply that reassessment of the government's obligations under a guarantee would be required. However, to promote consistency in practice, TIC recommends that this requirement be made more explicit in the final standard, along with the frequency of reassessment (i.e., annually v. as often as financial statements are prepared).

Accounting for Potential Recoveries of Payments under Guarantee Obligations

The ED does not address the recognition of receivables in connection with expected recoveries of payments made under a guarantee, thereby implying that such recognition would never be permissible. TIC believes there are circumstances where recognition of a receivable would be appropriate. For example, a redevelopment authority may have the ability to collect future tax increments in order to recover its costs; but, in the near term, the authority may be unable to pay its obligations. In that case, payments made by the guarantor of the authority's debt would be considered realizable and a receivable could be recognized if sufficient confidence exists that the payments made by the guarantor would be recovered. Therefore, because this issue will arise from time-to-time, the final standard should provide some guidance, even if such guidance is nothing more than a cross-reference to GASB Statement No. 62.

Illustrations of Journal Entries for Government-Wide and Governmental Fund Financial Statements

TIC recommends that the final standard include sample journal entries for guarantees extended and received. TIC believes this would enhance the value of the illustrations and would best illustrate the differences in accounting between the government-wide and governmental fund financial statements. Illustrative journal entries would also emphasize the need for a periodic reassessment of the recognition and measurement provisions of the ED.

Presentation of Guarantees for Discretely Presented Component Units within the Government-Wide Financial Statements

TIC questioned whether the respective sides of a nonexchange guarantee transaction would be recognized in the columns for discretely presented component units and the

government-wide column. TIC recommends that appropriate guidance be added to the final standard on this issue.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

A handwritten signature in black ink that reads "Karen Kerber". The signature is written in a cursive style with a large initial 'K'.

Karen Kerber, Chair
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees