

Governmental Accounting Standards Series

EXPOSURE DRAFT

Proposed Statement of the Governmental Accounting Standards Board

Accounting and Financial Reporting for Nonexchange Financial Guarantee Transactions

This Exposure Draft of a proposed Statement of Governmental Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Director of Research and Technical Activities
Project No. 19-18

Comment Deadline: September 28, 2012



Governmental Accounting Standards Board
of the Financial Accounting Foundation

**ACCOUNTING AND FINANCIAL REPORTING FOR
NONEXCHANGE FINANCIAL GUARANTEE TRANSACTIONS
REQUEST FOR WRITTEN COMMENTS**

Deadline for submitting written comments: September 28, 2012

Requirements for written comments. Comments should be addressed to the Director of Research and Technical Activities, Project No. 19-18, and emailed to director@gasb.org or mailed to the address below.

OTHER INFORMATION

Public hearing. The Board has not scheduled a public hearing on the issues addressed in this Exposure Draft.

Public files. Written comments will become part of the Board's public file and will be available for inspection at the Board's offices. Copies of those materials may be obtained for a specified charge. The GASB will make all comments publicly available by posting them to the Projects portion of its website.

Orders. Any individual or organization may obtain one copy of this Exposure Draft on request without charge until September 28, 2012, by writing or phoning the GASB Order Department. For information on prices for additional printed copies and printed copies requested after that date, please contact the Order Department. The Exposure Draft also may be downloaded from the GASB's website at www.gasb.org.

Governmental Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Telephone Orders: 1-800-748-0659

Please ask for our Product Code No. GE86.

GASB publications also may be ordered at www.gasb.org.

Copyright © 2012 by Financial Accounting Foundation. All rights reserved. Permission is granted to make copies of this work provided that such copies are for personal or intraorganizational use only and are not sold or disseminated and provided further that each copy bears the following credit line: "Copyright © 2012 by Financial Accounting Foundation. All rights reserved. Used by permission."

Notice to Recipients of This Exposure Draft

The Governmental Accounting Standards Board (GASB) is responsible for developing standards of state and local governmental accounting and financial reporting and other accounting and financial reporting communications that will (1) result in useful information for users of financial reports and (2) guide and educate the public, including issuers, auditors, and users of those financial reports.

The due process procedures that we follow before issuing our standards and other communications are designed to encourage broad public participation in the standards-setting process. As part of that due process, we are issuing this Exposure Draft setting forth a proposed Statement that would address accounting and financial reporting issues related to financial guarantees extended and received that are nonexchange transactions.

We invite your comments on all matters in this proposed Statement. Because this proposed Statement may be modified before it is issued as a final Statement, it is important that you comment on any aspects with which you agree as well as any with which you disagree. To facilitate our analysis of comment letters, it would be helpful if you explain the reasons for your views, including alternatives that you believe we should consider.

All responses are distributed to the Board and to staff members assigned to this project, and all comments are considered during the Board's deliberations leading to a final Statement. When the Board is satisfied that all alternatives have been adequately considered and modifications, if any, have been made, a vote is taken on the Statement. A majority vote is required for adoption.

Summary

Some governments extend financial guarantees for the obligations of another government, a not-for-profit entity, or a private entity without directly receiving consideration of equal value in exchange (a nonexchange transaction). As a part of this nonexchange financial guarantee, a government commits to indemnify the holder of the obligation if the entity that issued the obligation does not fulfill its payment requirement. Also, some governments issue obligations that are guaranteed by other entities in a nonexchange transaction. The objective of this proposed Statement is to improve accounting and financial reporting by state and local governments that extend and receive nonexchange financial guarantees.

This Statement would require a government that extends a nonexchange financial guarantee to recognize a liability when qualitative factors or historical data indicate that it is more likely than not that the government will make a payment on the guarantee. The amount of the liability would be the best estimate of the future outflows expected to be incurred. When there is no best estimate but a range of the estimated future outflows can be established, the amount of the liability would be the minimum amount within the range.

This Statement would require a government that is required to repay a guarantor for making a payment on a guaranteed obligation or legally assuming the guaranteed obligation to continue to report a liability until legally released as an obligor. When a government is released as an obligor, the government would recognize revenue as a result of being relieved of the obligation.

This Statement also would clarify the information required to be disclosed by governments that extend and receive nonexchange financial guarantees.

The provisions of this Statement would be effective for periods beginning after June 15, 2013. Earlier application would be encouraged. Except for disclosures related to cumulative amounts paid or received in relation to a financial guarantee, the provisions of this Statement would be required to be applied retroactively. Disclosures related to cumulative amounts paid or received in relation to a financial guarantee may be applied prospectively.

How the Changes in This Statement Would Improve Financial Reporting

The requirements of this Statement would enhance comparability of financial statements among governments by requiring consistent reporting by governments that extend nonexchange financial guarantees and by requiring consistent reporting by governments that receive nonexchange financial guarantees. This Statement also would enhance the information disclosed about a government's obligations and risk exposure from extending nonexchange financial guarantees. This Statement also should enhance users' ability to assess the probability that governments will repay obligation holders by requiring disclosures about obligations that are issued with this type of financial guarantee.

Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental entities, including general purpose governments; public benefit corporations and authorities; public employee retirement systems; and public utilities, hospitals and other healthcare providers, and colleges and universities. Paragraphs 4 and 5 discuss the applicability of this Statement.

Proposed Statement of the Governmental Accounting Standards Board

Accounting and Financial Reporting for Nonexchange Financial Guarantee Transactions

June 18, 2012

CONTENTS

	Paragraph Numbers
Introduction.....	1–3
Standards of Governmental Accounting and Financial Reporting	4–14
Scope and Applicability of This Statement	4–6
Recognition and Measurement of Financial Guarantees	7–12
Governments Extending Financial Guarantees.....	7–10
Recognition and Measurement in Economic Resources Financial Statements.....	9
Recognition and Measurement in Current Financial Resources Financial Statements	10
Governments Receiving a Financial Guarantee.....	11–12
Disclosures	13–14
Effective Date and Transition	15–16
Appendix A: Background	17–21
Appendix B: Basis for Conclusions and Alternative View	22–54
Appendix C: Illustrations	55
Appendix D: Codification Instructions	56–57

Proposed Statement of the Governmental Accounting Standards Board

Accounting and Financial Reporting for Nonexchange Financial Guarantee Transactions

June 18, 2012

INTRODUCTION

1. Some governments guarantee financial obligations of other governments or nongovernmental entities in which equal value is not received in return for the guarantee—a nonexchange transaction. When a government extends a financial guarantee that is a nonexchange transaction, the government has agreed to indemnify a third party if the entity that issued the guaranteed obligation does not fulfill its requirements under the obligation. Generally, these types of guarantees are extended by governments as part of their mission to assist other governments, nongovernmental entities, or individuals within the government’s jurisdiction.

2. Similarly, a government may receive a financial guarantee for an obligation it has issued in which equal value is not provided by the government in return. For example, a school district may receive a financial guarantee from the state for the district’s debt service payments on construction bonds the school district has issued.

3. The objective of this Statement is to improve the recognition, measurement, and disclosure guidance for state and local governments that have extended or received financial guarantees that are nonexchange transactions.

STANDARDS OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING

Scope and Applicability of This Statement

4. This Statement establishes accounting and financial reporting standards for financial guarantees that are nonexchange transactions (nonexchange financial guarantees) extended or received by a government. As used in this Statement, a financial guarantee extended that is a nonexchange transaction is 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. The provisions of this Statement should be applied to financial statements of all state and local governments.

5. This Statement does not apply to guarantees related to special assessment debt within the scope of Statement No. 6, *Accounting and Financial Reporting for Special Assessments*.

6. This Statement amends Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, paragraph 3; Statement No. 33, *Accounting*

and Financial Reporting for Nonexchange Transactions, paragraph 5; and Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, paragraphs 98, 109, 110, and 124.

Recognition and Measurement of Financial Guarantees

Governments Extending Financial Guarantees

7. A government that has extended a nonexchange financial guarantee should consider qualitative factors in assessing the likelihood that the government will make a payment in relation to the guarantee. Examples of such qualitative factors relevant to the entity that has issued the guaranteed obligation include, but are not limited to, the following:

- a. Initiation of the process of entering into bankruptcy or a financial reorganization
- b. Breach of a debt contract in relation to the guaranteed obligation, such as a failure to meet rate covenants, failure to meet coverage ratios, or default or delinquency in interest or principal payments
- c. Indicators of significant financial difficulty, such as the failure to transfer deposits from debt service funds to paying agents or trustees; the draw on a debt service reserve fund; the initiation of the process by a creditor to intercept receipts to make a debt service payment; debt holder concessions; significant investment losses; loss of a major revenue source; significant increase in noncapital disbursements in relation to operating or current revenues; or commencement of financial supervision by another government.

8. Some governments extend similar nonexchange guarantees to more than one individual or entity. For example, a state government may guarantee debt issued for construction of capital assets for qualifying school districts within the state. When a government extends similar guarantees to a group, the government should consider applicable qualitative factors in relation to the issuers 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. For example, a government that has historical data on the default frequency of a group of guarantees should consider that data in relation to its outstanding guarantees to assess the likelihood that it will make a payment on one or more of the guarantees within the group.

Recognition and Measurement in Economic Resources Financial Statements

9. When qualitative factors or historical data as discussed in paragraphs 7 and 8 indicate that it is more likely than not¹ that a government will make a payment on nonexchange financial guarantees it extended, the government should recognize a liability and an expense in financial statements prepared using the economic resources measurement focus. The amount recognized should be the best estimate of the discounted present value of the future outflows expected to be incurred as a result of the guarantee. If

¹As used in this Statement, the term *more likely than not* means a likelihood of more than 50 percent.

there is no best estimate of the future outflows expected to be incurred but a range of estimated future outflows can be established in which no amount within that range appears to be a better estimate than any other amount, the minimum amount in that range should be recognized.

Recognition and Measurement in Current Financial Resources Financial Statements

10. When qualitative factors or historical data as discussed in paragraphs 7 and 8 indicate that it is more likely than not that a government will make a payment on nonexchange financial guarantees it extended, the government should recognize a fund liability and an expenditure in financial statements prepared using the current financial resources measurement focus to the extent the liability is normally expected to be liquidated with expendable available financial resources. Liabilities for nonexchange financial guarantees extended are normally expected to be liquidated with expendable available financial resources when payments are due and payable on the guaranteed obligation.

Governments Receiving a Financial Guarantee

11. When a government is required to repay a guarantor for payments made on the government's obligations, the government should reclassify that portion of its liability for the guaranteed obligation as a liability to the guarantor. The government that issued the guaranteed obligation should continue to report the obligation as a liability until all or a portion of the liability is legally released, such as when a Plan of Adjustment is confirmed by the court in the case of bankruptcy. Interest expense/expenditures reported should be reduced by the interest-related payments made by the guarantor that are not required to be repaid.

12. When a government is legally released as an obligor from its own obligations and from any liability to the guarantor, the government should recognize revenue to the extent of the reduction of guaranteed liabilities.

Disclosures

13. A government that extends nonexchange financial guarantees should disclose the following information about the guarantees by type of guarantee:

- a. A description of the obligations that are guaranteed identifying:
 - (1) The legal authority and limits for providing financial guarantees
 - (2) The relationship to the entity or entities issuing the obligations that are guaranteed
 - (3) The length of time of the guarantees
 - (4) A description of arrangements for recovering payments from the issuers of the obligations that are guaranteed
- b. For guarantees extended that have been recognized as liabilities in the financial statements, a brief description of the timing of recognition and measurement of the

liabilities and a table presenting the changes in recognized guarantee liabilities, including the following:

- (1) Beginning-of-year balances
 - (2) Increases, including initial recognition and adjustments increasing estimates
 - (3) Guarantee payments made and adjustments decreasing estimates
 - (4) End-of-year balances
- c. The amount of outstanding guarantees
- d. For outstanding guarantees in which indemnification payments have been made:
- (1) Cumulative amounts that have been paid
 - (2) Amounts expected to be recovered.

14. A government that has outstanding obligations that have been guaranteed by another entity should disclose the following information about the guarantees by type of guarantee:

- a. The name of the entity providing the guarantee
- b. The amount of the guarantee
- c. The length of time of the guarantee
- d. The amount paid by the entity extending the guarantee on obligations of the government during the current reporting period
- e. The cumulative amount paid by the entity extending the guarantee on outstanding obligations of the government
- f. A description of requirements to repay the entity extending the guarantee
- g. The amount required to repay the entity providing the guarantee.

EFFECTIVE DATE AND TRANSITION

15. The provisions of this Statement are effective for periods beginning after June 15, 2013. Earlier application is encouraged. In the first period that this Statement is applied, changes made to comply with this Statement should be treated as an adjustment of prior periods, and financial statements presented for the periods affected should be restated. If restatement of the financial statements for prior periods is not practical, the cumulative effect of applying this Statement should be reported as a restatement of beginning net position (or fund balance or fund net position, as appropriate) for the earliest period restated (generally the current period). In the first period that this Statement is applied, the financial statements should disclose the nature of the restatement and its effect.

16. The requirements for disclosure of cumulative amounts in paragraphs 13 and 14 may be applied prospectively. If applied prospectively, the disclosure should state the date through which the cumulative amounts are determined.

<p style="text-align: center;">The provisions of this Statement need not be applied to immaterial items.</p>

Appendix A

BACKGROUND

17. The current economic environment is such that investors in obligations are seeking additional credit enhancements and assurances, including financial guarantees, to minimize the possibility of nonpayment. Financial guarantees that are extended by governments can be associated with commitments related to debt issued by other governmental entities, not-for-profit entities, and, in certain cases, for-profit entities. In many financial guarantee arrangements, a government extends a financial guarantee, or receives a guarantee for an obligation that it has issued, without receiving or paying equivalent value. In many circumstances, these financial guarantees that are nonexchange transactions are extended with the anticipation that the government issuing the guaranteed obligation will fulfill its payment obligations and no payment will be required by the guarantor.

18. Existing guidance applicable to state and local governments for these financial guarantee arrangements is found in GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. That guidance requires governments that guarantee the indebtedness of others to recognize a liability as a result of the guarantee when (a) it is probable that the government will be required to make a payment as a result of the guarantee and (b) the amount of the loss can reasonably be estimated. That guidance was incorporated into Statement 62 from FASB Statement No. 5, *Accounting for Contingencies*, FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, and FASB Interpretation No. 34, *Disclosure of Indirect Guarantees of Indebtedness of Others*. The primary objective of Statement 62 was not to deliberate accounting and financial reporting issues related to guidance incorporated into that Statement, including financial guarantee transactions.

19. In April 2010, a project proposal on financial guarantees was reviewed with the Governmental Accounting Standards Advisory Council (GASAC). The GASAC members rated the potential project a high priority. As a result of the perceived need for guidance and the feedback from the GASAC, a project on financial guarantees was added to the Board's research agenda in April 2010.

20. Based on the research findings and further GASAC feedback on a project prospectus, the project was moved to the Board's current agenda in April 2011 and deliberations began in July 2011.

21. The Board assembled a task force composed of members broadly representative of the GASB's constituency. The task force members reviewed and commented on papers prepared for the Board's deliberations and on drafts of this Statement. In addition, further input was sought from the GASAC members at its meetings.

Appendix B

BASIS FOR CONCLUSIONS AND ALTERNATIVE VIEW

22. This appendix discusses factors considered significant by Board members in reaching the conclusions in this Statement. It includes discussion of the alternatives considered and the Board's reasons for accepting some and rejecting others. Individual Board members may have given greater weight to some factors than to others.

Scope and Applicability of This Statement

23. In considering the scope of this Statement, the Board studied a broad range of activities that could be classified as financial guarantees and concluded that a financial guarantee should require a guarantor to perform an action under specified conditions. The Board believes the requirement of the guarantor to perform in accordance with the terms of the guarantee is the key element that provides value in the guarantee to the entity or individual holding the guaranteed obligation. The Board also concluded that the guarantor should be an entity separate from the entities involved in the underlying transaction being guaranteed. As a result, a financial guarantee would require the involvement of three separate entities. These entities are the holder of the obligation being guaranteed, the issuer of the obligation being guaranteed, and the entity extending the financial guarantee. The Board believes the involvement of three entities appropriately distinguishes a financial guarantee from the assurances provided by a guarantor in relation to repaying its own creditors.

24. The Board also considered "intercept" programs in which a government has the ability to withhold revenues that it collects for, or provides to, an issuer of an obligation to make payments on that obligation. In those circumstances, the Board concluded the withholding government has not provided a guarantee of the obligation that is within the scope discussed in the paragraph above. In essence, the withholding government is "garnishing" the issuing entity's own revenues, to the extent collected, to make the obligation payments.

25. The Board considered whether a primary government and its component units should be considered separate entities for purposes of determining whether three separate entities are involved in the guarantee transaction. In this circumstance, the Board concluded that because Statement No. 14, *The Financial Reporting Entity*, as amended, stipulates that a component unit should be a legally separate entity from a primary government, both blended and discretely presented component units should be considered separate entities for the purpose of applying this Statement.

26. During its initial deliberations, the Board determined that this project should be limited to nonexchange financial guarantees. The Board concluded that amending guidance related to 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.

Recognition and Measurement

27. Concepts Statement No. 4, *Elements of Financial Statements*, defines *liabilities* as “present obligations to sacrifice resources that the government has little or no discretion to avoid.” Concepts Statement 4 further defines an *obligation* as a “social, legal, or moral requirement, such as a duty, contract, or promise that compels one to follow or avoid a particular course of action.” The Board believes the extension of a nonexchange financial guarantee by a government is an obligation of the government, but an event that would cause recognition of a liability has not necessarily occurred as many nonexchange financial guarantees are extended without the expectation of a payment ever being made.

28. The Board considered several recognition points at which a guarantor government should recognize a liability for payments that the government may be required to make. The Board initially considered recognition based on the eligibility requirements set forth in paragraphs 19 and 20 of Statement 33. However, for most nonexchange financial guarantees, the allowable costs would be principal and interest payments made; therefore, a government that extends a guarantee would not report a liability until default occurred. Under that approach, the Board believes that recognition point would occur well after it is evident that a liability has been incurred. The Board also considered recognition of a liability as a result of extending a nonexchange financial guarantee when a payment is probable as would be required for recognizing a liability for a loss contingency based on the provisions of Statement 62. Paragraph 100 in Statement 62 defines *probable* as “the future event or events are likely to occur.” Again, the Board was concerned that the recognition of a liability based on the probable criterion is likely to occur for a nonexchange financial guarantee at a date that may be well after the point it is evident that a liability has been incurred.

29. The Board believes that determining whether a payment will be made as a result of a nonexchange guarantee extended requires a probability assessment. The Board concluded that recognition when a payment is *more likely than not* eliminates some of the concerns about the point at which a liability for the obligation is recognized, as previously discussed. A more-likely-than-not criterion requires recognition in circumstances in which there is a greater than 50 percent probability that the guarantor will make a payment as a result of a guarantee. The Board recognizes that both the determination of when a payment will more likely than not be required and when it is probable require the application of professional judgment in assessing probability. However, the Board believes that the facts and circumstances surrounding a specific nonexchange financial guarantee (“qualitative factors”) will assist financial statement preparers in determining whether a liability has been incurred as a result of the guarantees extended.

Qualitative Factors to Indicate Recognition

30. After considering several approaches, including the adoption of a more-likely-than-not principle without further clarifying guidance, the Board concluded that recognition of a liability resulting from a nonexchange financial guarantee should be based on the consideration of qualitative factors. The Board believes prior to a guarantor making a payment on a guarantee, the entity that issued the guaranteed obligations experiences one

or more predictive events, including negative economic events, violation of agreements related to the obligation, or initiation of the process of financial reorganization, including bankruptcy. The Board believes qualitative factors, such as those, in most circumstances will assist in assessing whether a payment will more likely than not be required as a result of the extension of the guarantee. Although the occurrence of these events may increase the probability that a payment will be required as a result of the guarantee, the Board believes that there generally will not be a specific point at which the government is certain that a payment will be required until the entity issuing the guaranteed obligation fails to make its required payment. Accordingly, the Board believes that the conclusion that a future payment is more likely than not going to occur will be a judgment based on facts and circumstances for each guarantee extended.

31. The Board believes that recognition of a liability from the extension of a nonexchange financial guarantee requires a two-step approach. First, a government considers qualitative factors or historical data, as discussed in paragraphs 7 and 8, to indicate whether the ability of the issuing entity to repay the guaranteed obligation has diminished since the guarantee was extended. Next, the government uses that information to assess whether it is more likely than not that it will be required to make a payment.

Measurement

32. To measure the liability, the Board considered (a) a fair value measurement approach that would measure the liability as the price required to exchange the liability in a deep and liquid market and (b) a cost accumulation approach that would measure the liability as the amount that the entity expects to spend to settle the liability. The Board concluded the cost accumulation approach of expected future outflows associated with the nonexchange financial guarantee was a more appropriate measurement approach because governments that extend nonexchange financial guarantees generally do not attempt to sell or transfer such guarantees to external entities.

33. The Board also considered two methodologies to measure the liability. One methodology derives from paragraphs 102–104 of Statement 62 for accrual of a liability for loss contingencies. Following that guidance, a liability is measured using a reasonably estimable amount or if the amount of loss is only reasonably estimable within a range, the best estimate within that range or the minimum amount of that range if there is no best estimate within the range. The other methodology considered was an expected cash flow approach as used in paragraphs 16 and 17 of Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. Following that guidance, a liability is measured as the sum of probability-weighted amounts from a range of possible estimated amounts.

34. The Board concluded that the measurement approach used in Statement 62 is more appropriate for measurement of a government's liability for an extended nonexchange financial guarantee. Unlike pollution remediation obligations, the Board could not identify a specific obligating event associated with nonexchange financial guarantees that would serve as a basis for applying the expected cash flows approach other than the actual extension of the guarantee. Because several nonexchange financial guarantees are one-

time transactions, the Board was concerned that the application of the expected cash flows approach 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.

35. The Board believes that when there is a best estimate of the amount a government will be required to pay, the government should recognize that amount as its liability. In cases in which there is no best estimate of the amount that a government will be required to pay, the Board believes the minimum amount within a range is the appropriate amount for the government to recognize.

Groups of Similar Guarantees

36. The Board believes that if a government has a history of extending similar nonexchange financial guarantees, or a group of guarantees, the government may be able to better assess whether a payment will be required based on its past experience rather than reliance on indicators relative to individual issuers within the group. For example, the knowledge that 1 in 20 guarantees extended for a student loan program has historically required an indemnification payment, may assist a government in evaluating whether a liability should be recognized using the more-likely-than-not recognition threshold. The Board believes that some governments extend groups of guarantees in which the probability of payment on any of the *individual* guarantees within the group is not more likely than not. However, historical data or experience may indicate that the probability of the guarantor government being required to make a payment on *at least one* of the guarantees within the group is more likely than not.

37. The Board believes that the historical default experience for similar nonexchange financial guarantees of a group may indicate that a guarantee payment will be required as a result of extending the guarantees. As a result, the Board concluded that a government that extends a group of similar nonexchange financial guarantees should recognize a liability when past experience or other qualitative factors indicate that it is more likely than not that a payment will be made on one or more of the guarantees within the group and that measurement of the liability should be based on that historical experience.

Recognition in Current Financial Resources Financial Statements

38. For recognition in financial statements prepared using the current financial resources measurement focus, this Statement provides that a liability that results from a nonexchange financial guarantee extended should be recognized to the extent the liability is normally expected to be liquidated with expendable available financial resources. This guidance is consistent with the recognition guidance provided in Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*, as amended, for liabilities that are not claims against current financial resources. The Board specified that in relation to a nonexchange financial guarantee extended, an amount "expected to be liquidated with expendable available financial resources" refers to a guarantee payment that is due and payable as of the end of the reporting period.

Governments Receiving a Guarantee

39. As previously discussed for recognition and measurement issues for governments that extend nonexchange financial guarantees, this type of guarantee is generally extended and received in situations in which an indemnification payment for the guarantee is not likely. This result is anticipated because (a) indemnification payments are only required when the government issuing the guaranteed obligation does not make a required repayment in accordance with the terms of the obligation and (b) the guarantee is extended with the expectation that the government issuing the obligation will fulfill its repayment obligation.

40. The Board considered whether recognition and measurement guidance for governments that issue guaranteed obligations should be symmetrical to the recognition and measurement requirements for governments that extend nonexchange financial guarantees. Symmetry with the recognition requirements the Board has provided for governments that extend a nonexchange financial guarantee would require a government that issued a guaranteed obligation to derecognize its liability to the obligation holder when it is more likely than not that the guarantor will make a payment on the guarantee. The amount derecognized would be measured in the same way as the liability of the guarantor government.

41. The Board also considered that Statement 62 prohibits governments from recognizing gain contingencies prior to the realization of the gain. Based on that consideration, an issuing government would not recognize the payment made by the guarantor prior to the guarantor making the payment.

42. After analyzing those approaches, the Board concluded that a government that issues a guaranteed obligation should recognize a reduction in its liability for the obligation only when the guarantor makes a payment on the nonexchange financial guarantee or legally assumes all or a portion of the guaranteed obligation from the issuing government. Unlike the nonexchange transactions addressed in Statement 33 in which symmetry was based primarily on performance obligations, until a payment is made or the obligation is legally assumed, the Board believes the government issuing the guaranteed obligation still has a present obligation to sacrifice resources to the obligation holder that it has little or no discretion to avoid. The Board also believes that another entity's interpretation of the events that have occurred, or will occur, in this situation should not impact the assessment made by a government for its own financial reporting because the application of professional judgment may lead to different conclusions.

Intra-Entity Recognition and Measurement

43. The Board also considered the application of the recognition and measurement requirements to arrangements in which a government extends a nonexchange financial guarantee for an obligation of another government within the same financial reporting entity, such as when a primary government extends a guarantee for an obligation of one of its component units. When the recognition criteria in this Statement for issuers and guarantors are applied to an intra-entity guarantee, both the government that extended the

guarantee and the government that issued the guaranteed obligation should recognize a liability within the financial statements of the reporting entity.

44. The Board believes that in most circumstances, the timing of applying recognition criteria on intra-entity transactions should be symmetrical. As a result, the Board considered not recognizing a liability in the financial statements of the guaranteeing government to prevent a “doubling up” of the liability. However, the Board also believes that a government that has guaranteed an obligation of another government within its reporting entity and the government that issued the guaranteed obligation both have a present obligation to sacrifice resources that they have little or no discretion to avoid. Therefore, the Board concluded the accounting and financial reporting guidance for nonexchange financial guarantees extended and received from entities outside of the reporting entity should also apply to intra-entity nonexchange financial guarantees.

Disclosures

45. Prior to this Statement, paragraphs 106–110 of Statement 62 required governments to disclose certain information about guarantees of the indebtedness of others. The Board believes the disclosure requirements in this Statement elaborate on the disclosures required by Statement 62 and provide more detail to users of the financial statements about the nonexchange financial guarantee arrangements and the underlying obligations being guaranteed. Statement 62 requires a government that guarantees the indebtedness of others to disclose the nature and amount of the guarantee with consideration given to disclosing the value of any recovery that may result. The Board concluded that specifying that the nature of a guarantee includes (a) the legal authority and limits of the guarantee, (b) the relationship to the entity issuing the guaranteed obligation, (c) the length of time of the guarantee, and (d) a description of arrangements for recovering guarantee payments and when those arrangements become effective are essential to understanding the risks associated with the guarantee. The Board also concluded that disclosure of the amount and changes in liabilities recognized related to guarantees in a schedule of changes, the amount of outstanding obligations guaranteed, and the amounts of guarantee payments made and expected to be recovered provide essential detail on the amounts recognized in the financial statements and on amounts that do not meet the criteria for recognition. The Board believes this additional information will allow users to better understand the responsibilities that the guarantor has to the issuers of the obligations that are guaranteed in a nonexchange transaction. During its deliberations, the Board noted that significant commitments are required to be disclosed by paragraph 158 of National Council on Governmental Accounting Statement 1, *Governmental Accounting and Financial Reporting Principles*. Accordingly, the Board believes that disclosure requirement does not need to be repeated in this Statement.

46. This Statement also requires disclosures by entities that issue obligations that are guaranteed in nonexchange transactions. The Board believes that the disclosures required by this Statement are essential to a user’s understanding of the risk mitigation provided by the guarantees associated with obligations that are outstanding.

Considerations Related to Benefits and Costs

47. The overall objective of financial reporting by state and local governments is to provide information to assist users (the citizenry, legislative and oversight bodies, and investors and creditors) in assessing the accountability of governments and in making economic, social, and political decisions. One of the principles guiding the Board's setting of standards for financial reporting is the assessment of expected benefits and the perceived costs. The Board strives to determine that standards (including disclosure requirements) address a significant user need and that the costs imposed through the application of its standards, compared with possible alternatives, are justified when compared to the expected overall public benefit.

48. Present and potential users are the primary beneficiaries of improvements in financial reporting. Persons within governments who are responsible for keeping accounting records and preparing financial statements, as well as managers of public services, also benefit from the information that is collected and reported in conformity with GASB standards. The costs to implement the standards are borne primarily by governments and, by extension, their citizens and taxpayers. Users also incur costs associated with the time and effort required to obtain and analyze information to meaningfully inform their assessments and decisions.

49. The Board's assessment of the benefits and costs of issuing new standards is unavoidably more qualitative than quantitative because there is no reliable and objective method for quantifying the value of improved information in financial statements. Furthermore, it is difficult to accurately measure the costs of implementing new standards until implementation has actually taken place. Nonetheless, the Board undertakes this assessment based on the available evidence regarding benefits and costs with the objective of achieving an appropriate balance between increasing benefits while minimizing costs.

50. The Board believes requirements of this Statement would enhance comparability of financial statements among governments by requiring consistent reporting by governments that extend nonexchange financial guarantees and requiring consistent reporting by governments that receive nonexchange financial guarantees. The Board also believes this Statement would enhance the information disclosed about a government's obligations and risk exposure from extending nonexchange financial guarantees. In addition, the Board believes this Statement should enhance users' ability to assess the probability that governments will repay obligation holders by requiring disclosures about obligations that are issued with this type of financial guarantee.

Effective Date and Transition

51. The provisions of this Statement are effective for periods beginning after June 15, 2013. The Board concluded that this effective date is appropriate because most governments that extend and receive nonexchange financial guarantees are aware of the amount of outstanding obligations related to nonexchange financial guarantees that they have extended or the amount of obligations they have issued that are guaranteed. Some

governments may wish to implement earlier than that date. Accordingly, this Statement encourages earlier implementation.

52. The Board believes that this Statement should be applied retroactively. However, the Board considered the potential for the lack of readily available information for the disclosure requirements of cumulative financial guarantee payments that have been made or received in prior years on outstanding guaranteed obligations by governments. Accordingly, the Board concluded that those disclosures may be provided prospectively.

Alternative View

53. One Board member has an alternative view for financial guarantee liability recognition for nonexchange transactions. Instead of paragraph 9's recognition requirements when qualitative factors indicate that it is "more likely than not that payment will be made toward guarantees," this member believes that the recognition of financial guarantee liabilities should follow the same "probable" contingent liability recognition requirement as other nonexchange and exchange transactions under paragraphs 100–105 of Statement 62. This member believes that financial guarantees are not important or different enough from other contingencies to merit blazing a new contingent liability recognition trail just for them. If the Board has concerns about the appropriateness of the contingent liability recognition requirements in Statement 62, this member believes the Board should establish a separate project to readdress all aspects of governments' contingent liability reporting.

54. This member also doubts the desirability of the proposed "more likely than not" liability recognition approach. This recognition requirement could be deemed inappropriate and possibly premature because the guaranteeing government may be required to report a liability in circumstances when it is almost less than likely of not being required to make a future payment on a guarantee.

Appendix C

ILLUSTRATIONS

55. The facts assumed in these examples are illustrative only and are not intended to modify or limit the requirements of this Statement or to indicate the Board's endorsement of the policies or practices shown. Application of the provisions of this Statement may require assessment of facts and circumstances other than those illustrated here. Existing standards may require disclosures in addition to those illustrated.

Illustration 1—Nonexchange Financial Guarantee between Two Governments

Facts and assumptions: The New Civic Center is a civic center district located within Any County, Any State. The New Civic Center and Any County are not part of the same financial reporting entity. The Any State Civic Center Act allows counties to extend nonexchange financial guarantees on bonds issued by civic center districts located within a county for improvements to facilities. Both the New Civic Center and Any County have a fiscal year-end of June 30. On November 1, 20X1, the District Trustees of the New Civic Center voted and approved the issuance of \$10 million in general obligation bonds to be issued on December 1, 20X1, for facility improvements. The bonds mature annually through December 1, 20Y1, with semiannual interest payments. On November 4, 20X1, the County Board of Any County voted to extend a nonexchange financial guarantee on the planned issuance by the New Civic Center with no requirements for the New Civic Center to repay Any County if payments are made as a result of the guarantee. On December 1, 20X1, the New Civic Center issued the \$10 million in general obligation bonds with Any County's guarantee.

In the last half of fiscal year 20X8, the New Civic Center's revenue from concerts and promotions begin to significantly decrease due to the construction of a competing civic center in a different civic center district located in a neighboring county. The decrease in revenue resulted in a violation of revenue coverage requirements contained in bond covenants. The New Civic Center made its required June 1, 20X8 interest payment on the bonds; however, it had to use all of the resources in the bond reserve account to do so. The use of these resources resulted in another violation of the of bond covenants. Based on these indicators, Any County determined that at June 30, 20X8, it is more likely than not the New Civic Center will be unable to make any of the remaining required debt service payments on the bonds. Any County determined that the present value of the future outflows of the guarantee was \$4.020 million at June 30, 20X8, using a discount rate of 5 percent. Beginning on December 1, 20X8, Any County was required to make a guarantee payment. Any County made the entire December 1, 20X8 payment for New Civic Center and also made the remaining required debt service payments on the guaranteed bonds until those bonds were paid.

Any County’s Financial Statements, June 30, 20X8

Accounting for the Guarantee

At June 30, 20X8, Any County records a liability and an expense for the \$4.020 million present value of the expected future outflows for the guarantee of the New Civic Center’s December 20X1 issuance of general obligation bonds in the financial statements prepared using the economic resources measurement focus.

Illustrative Disclosure

In 20X1, Any County guaranteed the 10-year, \$10 million December 20X1 general obligation bond issuance of the New Civic Center, a legally separate district located within Any County, in accordance with the Any State Civic Center Act. The bonds mature annually through December 1, 20Y1, with semiannual interest payments. In the event that the New Civic Center is unable to make a payment, Any County is required to make that payment. As a result of numerous bond covenant violations that occurred in 20X8, Any County determined that it was more likely than not that the County would be required to pay the remaining portion of the New Civic Center’s debt service payments based on this guarantee.

The liability recognized for nonexchange financial guarantees by Any County at June 30, 20X8, is as follows:

<u>Beginning of Year</u>	<u>Increases</u>	<u>Decreases</u>	<u>End of Year</u>
\$0	\$4,020,000	\$0	\$4,020,000

Any County’s Financial Statements, June 30, 20X9

Accounting for the Guarantee

On Any County’s June 30, 20X9 financial statements prepared using the economic resources measurement focus, Any County records a reduction in its guarantee liability for the outstanding balance of the New Civic Center’s December 20X1 issuance of general obligation bonds for a \$1 million principal payment made on the bonds and an expense of \$175 thousand for the interest payments made by Any County during the fiscal year. The County also reported the bond principal and interest payments as expenditures in its financial statements prepared using the current financial resources measurement focus.

Illustrative Disclosure

In 20X1, Any County guaranteed the 10-year, \$10 million December 20X1 general obligation bond issuance of the New Civic Center, a legally separate district located within Any County, in accordance with the Any State Civic Center Act. The bonds mature annually through December 1, 20Y1, with semiannual interest payments. In the event that the New Civic Center is unable to make a payment, Any County is required to make that

payment. As a result of numerous bond covenant violations that occurred in 20X8, Any County determined that it was more likely than not that the County will be required to pay the remaining portion of the New Civic Center’s debt service payments based on this guarantee. On December 1, 20X8, Any County began making payments on the New Civic Center’s bonds due to the New Civic Center failing to make payment. Any County has paid \$1 million in principal and \$175 thousand in interest on the guarantee through June 30, 20X9.

The liability recognized for nonexchange financial guarantees by Any County at June 30, 20X9, is as follows:

<u>Beginning of Year</u>	<u>Increases</u>	<u>Decreases</u>	<u>End of Year</u>
\$4,020,000	\$170,000	\$1,175,000	\$3,015,000

New Civic Center’s Financial Statements, June 30, 20X8

Accounting for the Guarantee

At June 30, 20X8, there is no impact on amounts reported on the New Civic Center’s statement of net position or statement of activities as a result of the guarantee from Any County.

Illustrative Disclosure

On December 1, 20X1, the New Civic Center issued \$10 million in 10-year general obligation bonds. The bonds mature annually on December 1 with semiannual interest payments. All required payments on the bonds are guaranteed by Any County in the event that the New Civic Center has insufficient resources to make required payments.

[The following illustrates disclosures required by NCGA Interpretation 6, *Notes to the Financial Statements Disclosure*, paragraph 4g, Statement No. 38, *Certain Financial Statement Note Disclosures*, paragraph 9, and Statement 62, paragraph 112.]

The New Civic Center is in violation of a bond covenant that requires the Center’s adjusted operating income to be at least 125 percent of annual debt service requirements. On June 1, 20X8, the New Civic Center used the resources in the debt service reserve fund for the bonds to make the interest payment. The New Civic Center has decreased its operating expenses to attempt repayment to the reserve fund. However, as a result of declining revenues, the New Civic Center anticipates that Any County likely will make all future debt service payments based on this guarantee.

New Civic Center’s Financial Statements, June 30, 20X9

Accounting for the Guarantee

On the New Civic Center’s June 30, 20X9 financial statements prepared using the economic resources measurement focus, the New Civic Center reports a reduction in its liability for the general obligation bonds and revenue in the amount of the \$1 million in payments made by Any County.

Illustrative Disclosure

On December 1, 20X1, the New Civic Center issued \$10 million in 10-year general obligation bonds. The bonds mature annually on December 1 with semiannual interest payments. All required payments on the bonds are guaranteed by Any County in the event that the New Civic Center has insufficient resources to make required payments. Any County has paid \$1 million in principal and \$175 thousand in interest on the guarantee during the year-ended June 30, 20X9, which are the cumulative amounts that have been paid by Any County.

[The following illustrates disclosures required by Statement 62, paragraph 112.]

As a result of declining revenues, the New Civic Center anticipates that Any County likely will make all future debt service payments based on this guarantee.

Illustration 2—Similar Nonexchange Financial Guarantees Extended by a Government to Multiple Entities

Facts and assumptions: Central State extends nonexchange financial guarantees for qualifying bonds issued by school districts within the State for construction of schools in accordance with the School Construction Act. Central State has determined based on historical evidence that 0.25 percent of the total amount of nonexchange financial guarantees extended eventually require a guarantee payment to be made, and 50 percent of guarantee payments made are recovered from the school district. Central State uses a 5 percent rate to discount its nonexchange financial guarantees.

At July 1, 20X0, Central State has recognized liabilities of \$18.5 million related to \$14.6 billion in nonexchange financial guarantees outstanding with varying dates of maturity through June 30, 20Z6. During the fiscal year ending June 30, 20X1, \$1.245 billion of the guaranteed obligations are repaid by the school districts that issued the obligations while Central State pays \$5 million on bond obligations of several school districts that did not make their required payments. Considering payments made during the current year in relation to the historical average of school districts that default, Central State estimates that its liability related to nonexchange financial guarantees will increase by \$1.875 million for nonexchange financial guarantees outstanding at June 30, 20X1. The increase in present value of the prior liability for the fiscal year ending June 30, 20X1, is \$1.5 million. In addition, during the fiscal year ending June 30, 20X1, Central State extends

\$900 million in nonexchange financial guarantees on bonds issued for school construction with varying dates of maturity through June 30, 20Z7.

Central State’s Financial Statements, June 30, 20X1

Accounting for the Guarantee

On Central State’s June 30, 20X1 financial statements prepared using the economic resources measurement focus, the State reports an increase in its liability related to nonexchange financial guarantees extended in the amount of \$1.5 million. This amount represents the present value of future outflows, \$2.250 million ($\$900 \text{ million} \times .0025$). The State believes that this amount will more likely than not be required for the guarantees based on the historic average of defaults. In addition, Central State recognizes a decrease in its liability related to nonexchange financial guarantees extended of \$5 million for the payments made on nonexchange financial guarantees during the year. Also, Central State recognizes an adjustment to increase its liability in the amount of \$3.375 million. That amount is based on a historical analysis of current nonexchange financial guarantees outstanding (\$1.875 million) and an increase for adjustment in present value (\$1.5 million). Central State also reported the \$5 million in bond principal and interest payments made as expenditures in its financial statements prepared using the current financial resources measurement focus.

Illustrative Disclosure

In accordance with the School Construction Act, Central State has guaranteed outstanding bond obligations of school districts within the State in the amount of \$14.250 billion at June 30, 20X1. The guarantees extend through the maturity dates of the bonds with the last maturity date being June 30, 20Z7. In the event that a school district is unable to make a required debt service payment on a guaranteed bond, Central State is required to make the payment.

The liability recognized for nonexchange financial guarantees by Central State at June 30, 20X1, is as follows:

<u>Beginning of Year</u>	<u>Increases</u>	<u>Decreases</u>	<u>End of Year</u>
\$18,500,000	\$4,875,000	\$5,000,000	\$18,375,000

For nonexchange financial guarantees outstanding at June 30, 20X1, Central State has paid \$32.675 million in debt service payments. Central State expects to recover \$16.485 million of this amount in future years.

Appendix D

CODIFICATION INSTRUCTIONS

56. The sections that follow update the June 30, 2011, *Codification of Governmental Accounting and Financial Reporting Standards*, for the effects of this Statement. Only the paragraph number of this Statement is listed if the paragraph will be cited in full in the Codification.

* * *

NONEXCHANGE FINANCIAL GUARANTEES

SECTION N30

Source: GASB Statement XX

.101–.114 [GASBS XX, ¶4–¶14, including headings and footnotes; change *Statement* to *section* and update cross-references.]

* * *

NONEXCHANGE TRANSACTIONS

SECTION N50

Source: GASB Statement XX

.103 [Insert at end of paragraph as follows:] The provisions of this section do not apply to guarantees. Section N30 provides guidance for accounting and financial reporting for financial guarantees extended and received that are nonexchange transactions (nonexchange financial guarantees). [GASBS 33, ¶5, as amended by GASBS XX, ¶4]

* * *

CLAIMS AND JUDGMENTS

SECTION C50

.103 [Replace *guarantees of the indebtedness of others* with *guarantees of the indebtedness of others in an exchange transaction*.] [GASBS 10, ¶3, as amended by GASBS XX, ¶4]

.150 [Replace *guarantees of the indebtedness of others* with *guarantees of the indebtedness of others in an exchange transaction*.] [NCGA 4, ¶9, as amended by GASBS 10, ¶3, GASBS 34, ¶69, GASBS 59, ¶3 and ¶8, and GASBS XX, ¶4; NCGA 4, ¶14]

* * *

57. The sections that follow update the Codification Instructions of Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-*

November 30, 1989 FASB and AICPA Pronouncements, for the effects of this Statement. The requirements of Statement 62 are effective for periods beginning after December 15, 2011.

* * *

NOTES TO FINANCIAL STATEMENTS

SECTION 2300

Sources: [Add the following:] GASB Statement XX

.107 [Add new subparagraphs fff and ggg as follows: add GASBS XX, ¶13–¶14 to sources:]

fff. Financial guarantees extended. (See Section F40, “Financial Guarantees,” paragraph .111.)

ggg. Financial guarantees received. (See Section F40, “Financial Guarantees,” paragraph .112.)

* * *

CLAIMS AND JUDGMENTS

SECTION C50

.153 [Replace *Guarantees of indebtedness of others* with *Guarantees of indebtedness of others in an exchange transaction*.] [GASBS 62, ¶98, as amended by GASBS XX, ¶4]

.164 [Replace second and third sentences as follows:] The common characteristic of those contingencies is a guarantee in an exchange transaction, normally with a right to proceed against an outside party in the event that the guarantor is called upon to satisfy the guarantee. Examples include guarantees of indebtedness of others in an exchange transaction and guarantees to repurchase receivables (or, in some cases, to repurchase the related property) that have been sold or otherwise assigned. [GASBS 62, ¶109, as amended by GASBS XX, ¶4]

.165 [Replace *guarantees of indebtedness of others* with *guarantees of indebtedness of others in an exchange transaction*.] [GASBS 62, ¶110, as amended by GASBS XX, ¶4]

* * *

DEBT EXTINGUISHMENTS AND TROUBLED DEBT RESTRUCTURING

SECTION D20

.101 [Replace the first sentence as follows:] Paragraphs .102 and .103 apply to all extinguishments of debt, whether early or not, except debt defeased by a current or advanced refunding, debt that is extinguished through a financial guarantee payment that is a nonexchange transaction, and debt that is extinguished through a troubled debt restructuring. [GASBS 62, ¶124, as amended by GASBS XX, ¶11]