American Accounting Association's Financial Accounting Standards Committee Response to FASB Invitation to Comment on the FASB Proposed Interpretation, Guarantor's Accounting and Disclosure Requirements, Including Indirect Guarantees of Indebtedness of Others (an Interpretation of FASB Statements 5, 57, and 107)

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The Financial Accounting Standards Committee of the American Accounting Association ("the Committee") is charged with responding to requests for comment from standard setters on issues related to financial reporting. The Committee is pleased to respond to the FASB's invitation to comment on the Proposed Interpretation, *Guarantor's Accounting and Disclosure Requirements, Including Indirect Guarantees of Indebtedness of Others*. The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

Our response to the Exposure Draft (ED) incorporates views expressed by previous Committees in prior communications with the FASB and IASC on guarantees related to transfers of financial assets and contingent liabilities.[1] Our response is presented in two sections. The first section describes the Committee's views on the proposals in the ED. The second section summarizes relevant academic accounting research findings that form the basis for the Committee's views. We note that this research does not directly investigate guarantees, but addresses issues related to guarantees. Given the lack of direct research on guarantees, the Committee's opinion is based on inferences from related research, as well as the Committee's understanding of the Conceptual Framework.

General Comments and Recommendation

The ED calls for recognition and increased disclosure of the liability associated with a guarantor's obligations under guarantees. The ED takes the position that a guarantee obligates the guarantor in two respects: a) the guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent element) and b) the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent element). The ED calls for the guarantor to recognize as a liability the fair value of the noncontingent element of the guarantee. In addition, the ED identifies four disclosure items to be provided by the guarantor. The ED is silent on subsequent measurement of the noncontingent

[1] These views can be found in the following publications: "Recommendations on Hedge Accounting and Accounting for Transfers of Financial Instruments," *Accounting Horizons*, March 2002, pp. 81-93 and "Response to IASC Exposure Draft Provisions, Contingent Liabilities, and Contingent Assets," *Accounting Horizons*, July 1998, pp. 192-200.

element of the liability under the guarantee. The ED confirms the applicability of FASB Statement No. 5, *Accounting for Contingencies*, to the contingent element of the guarantee.

The Committee strongly supports the disclosure requirements of the Proposed Interpretation. Research consistently documents that information reported about contingent liabilities is relevant in capital market valuation decisions. Prior research indicates that relevant information includes a description of the nature and uncertainty of the obligation, critical components of the estimate of the obligation, and other relevant facts needed to assess the likelihood and magnitude of the obligation.

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

With respect to liability recognition in the context of the Conceptual Framework, the Committee classified guarantees into two categories: (1) those associated with a related transaction, e.g., a sale to a customer and a subsequent guarantee of a loan from a third party to the customer and (2) those not associated with a specific transaction.

Guarantees Associated with Specific Transactions

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

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

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

Additionally, notwithstanding the Committee's views on the recognition requirements of the ED, we question whether recognition is not already required under existing GAAP for such guarantee transactions. In particular, we note that SFAC No. 5, ¶84(a), (b), and (d) states. "Revenue should not be recognized until the seller has substantially accomplished what it must do pursuant to the terms of the arrangement, which usually occurs upon delivery or performance of the services." In the case in which consideration is received at the inception of the guarantee, that portion of the consideration that relates to the guarantee should not be recognized until the service is performed. The fact that the consideration is not separately identifiable does not justify violation of revenue recognition principles.

Guarantees Not Associated with Specific Transactions

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

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

Review of Related Academic Accounting Literature

Capital Markets (Archival) Research

Capital markets research provides evidence that contingent liabilities are relevant to capital market participants' valuation decisions. For example, Banks and Kinney (1982) and Frost (1991) report negative market-adjusted stock returns for firms disclosing unexpected loss contingencies. Backmon and Vickrey (1997) find that reported loss contingencies influence the risk premia assessed on new bond issues. These findings suggest that market participants treat contingent obligations as liabilities when valuing firms even when such obligations are not recognized on the face of the financial statements.

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

Capital markets research also provides some evidence of consequences to firms of enhanced disclosure. The idea that enhanced disclosure lowers a firm's cost of capital has been proposed analytically for 20 years, and empirical evidence of the effects of enhanced disclosure have been documented recently. See Botosan (1997) for a summary of the theoretical literature and Leuz and Verrecchia (2000) for a summary of recent empirical literature. Other literature has documented additional consequences of increased disclosure. For example, Blacconiere and Patten (1994) and Blacconiere and Northcut (1997) document that chemical firms with more extensive environmental disclosures suffer less negative market reactions in response to environmental disasters (e.g., the chemical leak in Bhopal, India) or environmental legislation events. Finally, Linsmeier, Thornton, Venkatachalam, and Welker (2002) find decreased trading volume sensitivity to underlying market/price changes after disclosure of FRR No. 48 market risk information. Thus, research supports the idea that firms receive some benefits from increased disclosure.

Most capital markets research takes as given the belief that capital markets are efficient with respect to publicly available information. This research then tests for the value relevance of various types of information. As noted above, research taking this approach indicates that footnote disclosures on contingent liabilities are value relevant. Some studies, however, have relaxed the assumption of market efficiency and investigated whether market participants *correctly* impound footnote disclosures based on the expected impact from models linking specific footnote information and stock price. Two studies have concluded that prices partially ignore footnote disclosures on oil and gas reserves and pensions and relative to the predicted implications of the models (Harris and Ohlson 1987, Landsman and Ohlson 1990). The results of these studies are difficult to interpret; however, because departures from predicted values may reflect measurement error, investors failing to fully impound information due to processing biases, or investors appropriately discounting the disclosed item due to signals about the item's reliability inherent in recognition/disclosure rules.

Experimental Research

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

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

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

Finally, experimental research suggests that less-knowledgeable investors are more likely to be affected by the placement of financial information than more-knowledgeable investors such as analysts. First, less-knowledgeable investors' lack of understanding about the importance of various financial data for investment purposes leads them to read financial statements sequentially (Bouwman, Frishkoff, and Frishkoff 1987; Hunton and McEwen 1997). Since footnotes typically are placed at the end of financial statements, less-knowledgeable investors may ignore footnotes due to information overload, or place less weight on this information. Second, less-knowledgeable investors must rely on the financial statements to signal the importance of information and may infer that information placed in footnotes is less important for evaluating firm performance than information placed on the face of the footnotes.

Overall, experimental research supports the value of information related to contingent liabilities such as guarantees, and suggests that recognition versus disclosure of such information can make a difference. Specifically, financial statement users may not incorporate fully into their judgments and decisions information that is only disclosed in the footnotes due to information overload. Additionally, some financial statement users appear to use placement in financial statements as a signal about the nature and importance of information. Research indicates that these effects may manifest most for less-sophisticated financial statement users.

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