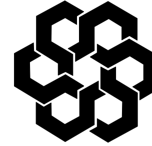

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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**24 January 2007, London**
Project:	**Financial Instruments – Due Process Document (DPD)**
Subject:	**Guaranteed liabilities (Agenda paper 7)**

BACKGROUND

1. Paper 12D from the last set of DPD papers discussed the measurement of certain types of liabilities from a debtors' perspective, namely:

    a. Collateralized liabilities, and

    b. Liabilities with third-party contractual and statutory guarantees.

Collateralized liabilities

2. That paper argued that collateral does affect the fair value of a liability both to the debtor and the creditor if the collateral affects the probability of settlement and timing of the settlement.

Third-party contractual guarantees

3. Paper 12D argued, however, that the existence of a third-party contractual guarantee does not usually affect the measurement of the guaranteed liability from the debtor's perspective.

4. If the debtor is not released from its obligation under the guaranteed debt even if the guarantor pays the creditor, the guarantee has no effect on the fair value of the debt instrument to the debtor. In effect, such a guarantee is a put option written by the guarantor and held by the creditor. That put option is exercisable only under certain conditions specified in the guarantee agreement, and the exercise price of that option is probably equal to the unpaid portion of the debt. If that option becomes exercisable, and the creditor exercises the option, the only thing that has changed from the perspective of the debtor is the identity of the creditor; that is, the guarantor has now become the creditor[1].

5. However if payment of the guarantee by the guarantor to the creditor does result in the release of the debtor from its obligation, that guarantee would affect the fair value of the liability to the debtor – as well as resulting in the debtor having a right to a potential benefit under certain circumstances. If the debtor runs into financial difficulty, the guarantor has promised to step into the debtor's position and settle the debt. Such a guarantee represents an asset of the debtor because it can be used to settle the debtor's liability - one of the potential uses of assets. The fair value of the liability to the debtor would be based on the combined probability of cash flows from the debtor and cash flows from the guarantor[2]. However, guarantees that result in the release of the debtor from their obligation are likely to be rare in practice because of the moral hazard involved.

[1] Alternatively, the obligation of the debtor may remain to the creditor, with the creditor having an obligation to pay any recovery proceeds to the guarantor.

[2] If the guarantor cannot pay, then the debtor is still obligated.

PURPOSE OF THIS PAPER

6. This paper:

    a. Provides some examples illustrating and comparing collateralized liabilities, uncollateralized liabilities and liabilities with a third party contractual guarantee.

    b. The implications of bundling a liability with a contractual guarantee and the debtor measuring them together.

    c. Measurement of liabilities with statutory or other non-contractual guarantees.

7. As in the previous paper 12D, this paper focuses on the measurement by the debtor.

CONTRACTUAL GUARANTEES

Should the identity of the purchasing entity affect the measurement of a guaranteed liability by the debtor?

8. Contractual guarantees could be purchased by a number of different parties. However, the identity of the party that purchases the guarantee should not affect the measurement of the debt instrument by the debtor. The purchase of the guarantee is a *past* cash outflow (that presumably resulted in a larger past cash inflow for the debtor if the debtor paid for the guarantee) but the fair value measurement of any financial instrument is affected by the timing or amount of *future* cash flows only.

Worked examples of collateralized, uncollateralized and contractually guaranteed liabilities

9. The following simple example compares and contrasts collateralized, uncollateralized and contractually guaranteed liabilities.

10. The example assumes an obligation by the debtor to repay CU105 in one year.

11. The contractually guaranteed liability assumes that the debtor purchases the guarantee and then transfers the guarantee to the creditor on issuance of the liability.

Example

	Collateralized	Uncollateralized	Guaranteed
Repayment amount in 1 year (CU)	105	105	105
Interest rate	5%	8%	5%
Proceeds from loan (CU)	100	97.22	100
Cost of guarantee (CU)	-	-	2.78
Net proceeds	100	97.22	97.22
Cost of funding (CU)	5	7.78	7.78
Cost of funding (%)	5%	8%	8%

12. In each situation the debtor has an obligation to repay CU105 in one year.

13. However by collateralizing the liability and increasing the certainty of settlement and timing of the settlement the debtor is able to obtain funding at 5% and raise proceeds of CU100. We are not going to discuss this situation further.

14. The debtor could raise proceeds of CU97.22 by issuing an uncollateralized liability. Alternatively the debtor could raise gross proceeds of CU100 by issuing a liability that has a third-party contractual guarantee. In order to obtain that guarantee the debtor would have to pay CU2.78 to the guarantor, resulting in the debtor obtaining net proceeds of CU97.22 – the same as if the debtor had issued an uncollateralized liability.

15. There are two observations arising from this example:

    a. By purchasing the guarantee, the debtor has exchanged one cash outflow (the purchase of the guarantee – CU2.78) for a greater cash inflow on the liability (CU100 instead of CU97.22). However those are all past cash flows, once the debtor has issued the liability and transferred the guarantee. The future cash flows for the uncollateralized liability and the

guaranteed liability are the same – namely the obligation of CU105 in one year – and the debtor has no potential future benefit from the contractual guarantee. Given that the uncollateralized and guaranteed liability have the same future cash flows (and hence costs), the same discount rate should be used for measuring both liabilities by the debtor (8% in this example).

b. This example assumes that markets are efficient. In reality the cost of purchasing the guarantee could be different than the benefits of the coupon differential between a guaranteed and uncollateralized liability. If this was the case, a gain or loss would be recognized in relation to the guaranteed by the debtor (see accounting entries below).

Example *(continued)* – accounting entries for the uncollateralized liability

Accounting entries by debtor on issuance	CU
Dr Cash (receipt from issuance of liability)	97.22
Cr Liability (fair value)	97.22
Subsequent accounting entries by debtor	CU
Dr Profit or loss (net during life of liability)	7.78
Cr Liability (net during life of liability)	7.78
Dr Liability (on repayment of liability)	105.0
Cr Cash (on repayment of liability)	105.0

16. The debtor recognizes the changes in the fair value of the liability that, during the entire period, will result in a net debit to profit or loss of CU7.78.

Example *(continued)* – accounting entries for the guaranteed liability

Accounting entries by debtor on issuance	CU
Dr Asset (contractual guarantee before transfer)	2.78
Cr Cash (payment for contractual guarantee by debtor)	2.78
Dr Cash (receipt from transfer of guarantee and issuance of loan)	100
Cr Contractual guarantee asset	2.78
Cr Liability (fair value)	97.22
Subsequent accounting entries by debtor	CU
Dr Profit or loss (net during life of liability)	7.78
Cr Liability (net during life of liability)	7.78

Dr Liability (on repayment of liability)	105.0
Cr Cash (on repayment of liability)	105.0

17. The subsequent accounting for the liability that is guaranteed by a contractual guarantee is the same as for the uncollateralized liability. This reflects the fact that the obligations of the debtor are the same in both situations.

What would change if we bundled the contractual guarantee with the liability and the debtor measured them together?

18. The previous section discussed the debtor measuring the guaranteed liability separately from the guarantee.

19. If the debtor measured the liability by taking the effect of the guarantee into account, then the debtor would also have to recognize some type of asset. This can be illustrated by using the previous example of the guaranteed liability.

Example *(continued)* – accounting entries for the guaranteed liability

Accounting entries by debtor on issuance	CU
Dr Asset (contractual guarantee before transfer)	2.78
Cr Cash (payment for contractual guarantee by debtor)	2.78
Dr Cash (receipt from transfer of guarantee and issuance of loan)	100
Dr Asset	2.78
Cr Contractual guarantee asset (transferred to creditor)	2.78
Cr Liability (fair value)	100

Subsequent accounting entries by debtor	CU
Dr Profit or loss (net during life of liability)	5.0
Cr Liability (net during life of liability)	5.0
Dr Profit or loss (during life of recognized asset)	2.78
Cr Asset (during life of recognized asset)	2.78

20. Using such an approach, the liability would be measured by the debtor by discounting CU105 for one year at a rate of 5%.

21. Some observations are:

   a. The debtor would have to recognize an asset of some type (or alternatively debit earnings) following the transfer of the financial guarantee to the creditor. It is not clear what such an asset would be or represent.

   b. The guaranteed liability would be accounted for differently than that of an uncollateralized liability that has exactly the same future cash flows.

   c. The guarantor would report a liability of CU2.78. In addition the debtor would also be recognizing a liability of CU2.78 within the fair value measurement of the guaranteed liability. Effectively, two different entities would be recognizing the same liability.

Staff recommendation

22. The staff believes that a third-party contractual guarantee does not affect the fair value to the debtor of the liability related to the contractual guarantee, unless payment of the guarantee by the guarantor to the creditor results in the release of the debtor from its obligation.

23. If payment of the guarantee by the guarantor to the creditor results in the release of the debtor from its obligation, the debtor should recognize an asset as well as measuring the fair value of the liability based on the combined probability of cash flows from the debtor and cash flows from the guarantor.

24. **Questions to the Boards:**

   a. Do you want to state a preliminary view about how third-party contractual guarantees affect the fair value measurement of a liability for the debtor? If so, what is that view?

   b. **If you believe you could answer those questions if some additional information were provided, what additional information do you need?**

STATUTORY (OR REGULATORY) FINANCIAL GUARANTEES

25. Another form of a guarantee for certain liabilities is that provided by a government or government agency. Such guarantees commonly exist in regulated financial service markets for retail investors.

26. The question of how to treat such a guaranteed liability is also related to an issue discussed in the first series of DPD papers - the possible interaction between the law and the rights and obligations that form a contract.

27. An example is deposit insurance. That insurance is provided by a government or government agency and covers all liabilities that have specific characteristics (typically retail deposits up to a certain size). The deposit taking entities are, in exchange for this guarantee, subject to specific regulatory oversight. Typically, if such guaranteed liabilities are to be transferred, they may only be transferred to another entity whose deposits are also covered by the insurance scheme.

28. Unlike the contractual guarantees previously discussed, deposit insurance is statutory in nature. It is therefore not a financial instrument because it is not a contract or an ownership interest.

29. In addition, rather than simply paying out the guarantee if the deposit taking entity fails, the guarantor typically takes over the deposit-taking entity (or arranges a take-over of the deposit-taking entity or assumption of the guaranteed liabilities), hence ensuring that the insured liabilities are partially or wholly satisfied by the entity itself. As part of such an arrangement the regulator may also guarantee the value of the assets of the deposit-taking entity that is in trouble.

30. This suggests that any value in such statutory insurance schemes actually arises from the regulators' ability (and propensity) to intervene, rather than from the guarantee mechanism itself.

31. In the previous discussion on contractual guarantees this paper suggested that a contractual guarantee provided by a third-party should not affect the fair value

measurement of the liability by the debtor. This was because the obligation of the debtor was not affected by the contractual guarantee.

32. The staff believes that statutory and similar non-contractual guarantees do affect the insured obligations of a debtor – although this effect arises from the regulatory environment rather than the guarantee mechanism itself. This is because of the measurement effects of the regulatory environment within which an insured deposit-taking entity operates.

Staff recommendation

33. The staff believes that statutory deposit insurance and similar non-contractual guarantees do affect the debtor's obligation and should be included in the valuation of the liabilities with statutory and similar non-contractual guarantees by the debtor.

34. **Questions to the Boards:**

    a. Do you want to state a preliminary view about the measurement of liabilities with statutory and similar non-contractual guarantees by the debtor? If so, what is that view?

    b. **If you believe you could answer those questions if some additional information were provided, what additional information do you need?**