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FIN 45 Disclosure Requirements for Guarantees Mandate Fair Value at Inception

In an effort to improve financial reporting of guarantees, the FASB has issued Interpretation No. 45 (FIN 45), *Guarantor's Accounting and Disclosure Requirements for Guarantees*. FIN 45 clarifies disclosure requirements for guarantors under FASB Statement No. 5, *Accounting for Contingencies*.

The FASB believed that certain entities were not recognizing a liability for a guarantee issued unless it was likely that payments would be required under the guarantee. The Board decided that Statement 5 does not prohibit an entity from initially recognizing a liability.

FIN 45 states:

“A guarantor is required to recognize, at the inception of a guarantee, a liability for the obligations it has undertaken in issuing the guarantee, including its ongoing obligations to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur. The objective of the initial measurement of that liability is the fair value of the guarantee at its inception.”

FIN 45 covers guarantee contracts that have any of the following four characteristics:

- (1) contracts that contingently require the guarantor to make payments to the guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party (e.g., financial and market value guarantees)
- (2) contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an obligating agreement (performance guarantees)
- (3) indemnification agreements that contingently require the indemnifying party (guarantor) to make payments to the indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party, such as an adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law
- (4) indirect guarantees of the indebtedness of others

FIN 45 Disclosure Requirements for Guarantees Mandate Fair Value at Inception *(continued)*

The FASB believes that the new disclosure requirements will improve financial reporting by more accurately depicting a guarantor's assets and liabilities. It is expected that the initial recognition and measurement requirements will mainly affect accounting for transactions involving the issuance of a guarantee by one party to the other.

VALUATION PROCESS

Determining the fair value measurement of a contingent liability requires a complex valuation process since it is generally easier to determine the fair value of an event which is likely to occur as opposed to an event with a less certain income. The fair value of a guarantee should be based on the facts and circumstances surrounding the agreement. Valuation professionals consider a number of methodologies when valuing guarantees.

OPTION PRICING

One approach that can be utilized for valuing guarantees is an option pricing method which uses the guarantee as a put option. Guarantees are valuable to lenders because if a borrower fails to make debt payment obligations, the guarantee ensures precontracted payments. A guarantee is comparable to a put option since the lender has the option to sell the debt at a price which has been agreed upon. The holder of a put option has the right to sell an asset on or before a certain date for a certain price.

The value of the guarantee can be estimated by calculating the value of the put option. Factors such as the volatility of the underlying asset, the time to maturity, and the size of the investment affect the value of the guarantee, or option.

OTHER APPROACHES

Valuation professionals may also utilize a market approach, by looking at what comparable instruments with and without guarantees would trade at on the market. In a situation where market values of a security exist before and after a guarantee, a market valuation approach can also be employed. A traditional approach can also be taken in which loan payments are projected and a probability rate is assigned to each. A discount is then applied at a risk-free rate to determine the cumulative present value.

We have only briefly touched upon the approaches which can be utilized to value guarantees. Valuing contingent liabilities requires a careful examination of the facts and circumstances pertaining to the particular liability.

The new disclosure requirements apply to guarantees issued or modified after December 31, 2002. The provisions are effective for financial statements of interim or annual periods ending December 15, 2002. For more information regarding the valuation of guarantees, contact your Valuation Research representative or Dick Nordberg at (414) 221-6220. **VR**