PROPOSED FASB STAFF POSITION

No. FIN 45-b

Title: Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or Its Owners

Comment Deadline: August 8, 2005

Issue

1. Should a guarantor apply the recognition, measurement, and disclosure provisions of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* to a guarantee granted to a business or its owners that the revenue of the business (or a specific portion of the business) for a specified period of time will be at least a specified minimum amount (hereafter referred to as a minimum revenue guarantee)?

2. One example is a guarantee granted to a nonemployee physician by a not-for-profit health care facility that has recruited the physician to move to the facility's geographical area to establish a practice. The health care facility, as the guarantor, has agreed to make payments to the newly arrived physician (the guaranteed party) at the end of specific periods of time if the gross revenues (gross receipts) generated by the physician's new practice during that period of time do not equal or exceed a specific dollar amount.

3. Another example is a minimum revenue guarantee granted to a new day-care center by a corporation as an incentive for the center to locate near the corporation's main plant. The corporation, as the guarantor, has agreed to make monthly payments to the day-care center (the guaranteed party) over a specified term for any shortfall from the guaranteed minimum amount for each month.

Background

4. Paragraph 3 of Interpretation 45 specifies the scope of the Interpretation as follows:

> Except as provided in paragraphs 6 and 7, the provisions of this Interpretation apply to guarantee contracts that have any of the following characteristics:
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> a. Contracts that contingently require the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock,[1] or provision of services) to the guaranteed party based on changes in an underlying[2] that is related to an asset, a liability, or an equity security of the guaranteed party. Thus, for example, the provisions apply to the following:

(1) A financial standby letter of credit, which is an irrevocable undertaking (typically by a financial institution) to guarantee payment of a specified financial obligation
(2) A market value guarantee on either a financial asset (such as a security) or a nonfinancial asset owned by the guaranteed party
(3) A guarantee of the market price of the common stock of the guaranteed party
(4) A guarantee of the collection of the scheduled contractual cash flows from individual financial assets held by a special-purpose entity (SPE).

b. Contracts that contingently require the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, or provision of services) to the guaranteed party based on another entity's failure to perform under an obligating agreement (performance guarantees). Thus, for example, the provisions apply to a performance standby letter of credit, which is an irrevocable undertaking by a guarantor to make payments in the event a specified third party fails to perform under a nonfinancial contractual obligation.
c. Indemnification agreements (contracts) 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.
d. Indirect guarantees of the indebtedness of others, as that phrase is used in paragraphs 17 and 18 (and originally in Interpretation 34), even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

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[1] A scope exception from the initial recognition and measurement provisions of this Interpretation is provided in paragraph 7(d) for guarantees for which the guarantor's obligation would be reported as an equity item (rather than a liability) under generally accepted accounting principles (GAAP).

[2] Paragraph 540 of Statement 133 defines an *underlying* as "a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable." The occurrence or nonoccurrence of a specified event (such as a scheduled payment under a contract) is a variable that is considered an underlying under that definition, which is applicable in this Interpretation.

5. Paragraph 4 of that Interpretation points out that "…the scope of this Interpretation does not encompass indemnifications or guarantees of an entity's own future performance (for example, a guarantee that the guarantor will not take a certain future action)."

FASB Staff Position

6. The Board believes that a minimum revenue guarantee granted to a business or its owners meets the characteristics in paragraph 3(a) of Interpretation 45 because the guarantee's underlying (the business's gross revenues) is related to an asset or equity security of the guaranteed party. Revenues are the changes in a business's net assets because of transactions with customers. If the guaranteed party is the business itself, then its gross revenues are naturally related to an asset of the business. If the guaranteed party is an owner of the business, then the business's gross revenues are related to the owner's investment in the business. A minimum revenue guarantee granted to a business or its owners would not meet any of the scope exceptions in paragraphs 6 and 7 of that Interpretation. Consequently, the provisions of Interpretation 45 apply to the guarantor's accounting for that minimum revenue guarantee.

Effective Date and Transition

7. The FSP is effective for new minimum revenue guarantees issued on or after the beginning of the first fiscal quarter following the date that the final FSP is posted to the FASB website. Earlier application of the provisions of this FSP is permitted. For any minimum revenue guarantees issued prior to the initial application of the FSP and not accounted for under Interpretation 45, the retroactive application of the initial recognition and initial measurement provisions of Interpretation 45 is not permitted.

8. The disclosure requirements in paragraphs 13–16 of Interpretation 45 should be applied to all minimum revenue guarantees in financial statements of interim or annual periods ending after the beginning of the first fiscal quarter following the date that the final FSP is posted to the FASB website. Thus, the disclosure requirements in paragraphs 13–16 should be applied to any minimum revenue guarantees issued prior to the initial application of this FSP, regardless of whether those guarantees were recognized and measured under Interpretation 45.