The Guarantee Project (FIN 45)
Impact on Vendor Leasing

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This presentation reflects the interpretations and comments of Key Equipment Finance. Before entering into a leasing transaction, you should consult with your accounting and legal advisors.
Agenda

• FIN 45
• Fair Value Calculation Example
• Vendor Leasing Implications
• Revenue Recognition Issues
FIN 45 - Overview

- Fin 45 - Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others
- Expanded disclosure and recognition of guarantee obligations in financial statements
- Disclosure: financial statements issued after 12/15/02
- Recognition: guarantees issued or modified after 12/31/02
- Fair value of obligation reported as a liability on the guarantor’s financial statements
FIN 45 – Impacted Obligations

- Lessee residual value guarantees under operating leases
- Guarantees issued in conjunction with sale of assets, a product, a business
- All events tax indemnification
- Environmental indemnities
- Indirect guarantees of the indebtedness of others
- Guarantees of scheduled contractual cash flows
- Financial standby letters of credit
FIN 45 - Scope Exceptions

- Lessee residual value guarantees under capital leases
- Contingent rent obligations
- Guarantees whose existence prevents sale treatment
- Vendor rebates
- Indemnifications or guarantees of an entity’s own future performance
- Disclosure only for
  - A parent’s guarantee of its subsidiary debt
  - A guarantee issued between a parent and its subsidiary or corporations under common control
FIN 45 - Disclosures

• Disclose the worst-case potential future undiscounted cash flow impact of guarantee

• Nature of the guarantee
  – Term of guarantee
  – How the guarantee arose
  – Events or circumstances requiring performance

• The maximum potential amount of future payments

• The current carrying amount of the liability, if any

• Nature of recourse provisions or available collateral that would enable the guarantor to recover
FIN 45 - Measurement of Obligation

Determination of Fair Value

Market-based Fair Value

*If a market for similar guarantees does not exist then use*

Probability Weighted Cash Flows
FIN 45 - Probability Weighted Cash Flows

• FASB Concept Statement No. 7 – *Using Cash Flow Information and Present Value in Accounting Measurements*

• Company must estimate the cash flow effect of nonperformance on a guarantee

• Fair value is determined by
  – Simulating different cash flow scenarios
  – Probability-weighting each scenario
  – Discounting the results to account for the time value of money at a risk free rate
Fair Value Calculation Example

Lease example

$500,000 computer lease
12% expected FMV
Vendor provides $40,000 residual support to lessor

8% vendor guarantee
Vendor takes sales treatment
Fair Value Calculation Example

<table>
<thead>
<tr>
<th>Possible Asset Values</th>
<th>Guaranteed Payment</th>
<th>Probability of Occurrence</th>
<th>Weighted Expected Value</th>
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<td>20%</td>
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</tr>
<tr>
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<td>.80</td>
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<tr>
<td>Total</td>
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<td></td>
<td>1.80</td>
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</tbody>
</table>

Discount at risk free rate of 3.51(5 yr Ts) = 1.51%
Vendor Leasing Implications

• **Manufacturer guarantees**
  – Residual and credit support
  – Guarantees whose existence prevents the guarantor from recognizing a sale or the earnings from a sale are not included in scope

• **All events indemnifications**
  – Indemnify for adverse judgment in a lawsuit or adverse tax law changes or interpretations
  – Indemnities related solely to the lessee’s future performance are not included in FIN 45 “acts and omissions”

• **Intellectual property infringement indemnifications**
  – Product warranties scope exception; subject to disclosure
Revenue Recognition – Main Concepts

- SEC – SAB 101
  - Persuasive evidence of an arrangement exists
  - Delivery has occurred or services have been rendered
  - The seller’s price to the buyer is fixed or determinable
  - Collectibility is reasonably assured

- FAS 140 for transfers of sales-type/direct financing lease receivables and guaranteed residual values

- FAS 13 for assets subject to operating leases

- Earnings process not complete if seller has substantial continued involvement in a transaction

- Vendor recourse such as residual or credit guarantees may represent substantial continuing involvement depending on lease classification
Revenue Recognition – Right of Return

• FAS 48 “Revenue Recognition When Right of Return Exists”
  – The seller’s price to the buyer is substantially fixed or determinable at the date of sale
  – The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product
  – The buyer’s obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product
  – The buyer acquiring the product for resale has economic substance apart from that provided by the seller
  – The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer
  – The amount of future returns can be reasonably estimated
Revenue Recognition - Operating Leases

- FAS 13 paragraph 21 – substantial risks of ownership
- Substantial risks of ownership -upon default or termination of lease, the seller committed to
  - Acquire the lease or the property
  - Substitute an existing lease
  - Secure a replacement lessee or buyer for the property under a remarketing agreement
- Direct or indirect guarantee of lease payments is another form of risk of ownership (SEC 1999)
- Substantial risk: equals or exceeds 10% on a PV basis of the equipment’s fair value at the time of transfer
Revenue Recognition - Remarketing Agreements

- FAS 13: A remarketing agreement by itself does not disqualify sale accounting for the transaction if the seller
  
  A. Will receive a reasonable fee commensurate with the effort involved at the time of securing a replacement lessee or buyer for the property

  AND

  B. Is not required to give priority to the re-leasing or disposition of the property owned by the third-party purchaser over similar property owned or produced by the seller
Revenue Recognition - Software Issues

• SOP 97-2 Software Revenue Recognition
• Unbundle the hardware and software based on their relative fair values
  – Hardware (FAS 13), Software (SOP 97-2)
  – Exception: incidental software
• SOP 97-2
  – Persuasive evidence of an arrangement exists
  – Delivery has occurred
  – The vendor’s fee is fixed or determinable and collectibility is probable
• No portion of the fee can be subject to forfeiture, refund or other concession (extension of payment terms)
Revenue Recognition - Recourse Pooling

- Special considerations when selling equipment subject to operating leases or when buyer’s lease classification is not known
- When PV of vendors’ risk on a transaction with recourse is >10% of fair value of equipment, no sale recorded; profit deferred
- Risk of loss measured on a transaction by transaction basis
- Risk of loss measured on a pool level for homogeneous pools of transactions
  - Sale of assets occur over a short period
  - The assets have similar residual values
  - The leases are for similar terms/periods
  - Lessees with the same credit risk
- FIN 45 implications if vendor qualifies for sale treatment
Questions?