Statement of Financial Accounting Standards No. 125

Note: This Statement has been completely superseded

FAS125 Status Page
FAS125 Summary

Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

June 1996

Financial Accounting Standards Board
of the Financial Accounting Foundation
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Statement of Financial Accounting Standards No. 125

Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

June 1996

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FAS 125: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

FAS 125 Summary

This Statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. Those standards are based on consistent application of a *financial-components approach* that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. This Statement provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right—to pledge or exchange those interests.
c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

This Statement requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interests in the transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

This Statement requires that servicing assets and liabilities be subsequently measured by (a) amortization in proportion to and over the period of estimated net servicing income or loss and (b) assessment for asset impairment or increased obligation based on their fair values.

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This Statement requires that debtors reclassify financial assets pledged as collateral and that secured parties recognize those assets and their obligation to return them in certain circumstances in which the secured party has taken control of those assets.

This Statement requires that a liability be derecognized if and only if either (a) the debtor pays the creditor and is relieved of its obligation for the liability or (b) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

This Statement provides implementation guidance for assessing isolation of transferred assets and for accounting for transfers of partial interests, servicing of financial assets, securitizations, transfers of sales-type and direct financing lease receivables, securities lending transactions, repurchase agreements including "dollar rolls," "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishments of liabilities.

This Statement supersedes FASB Statements No. 76, *Extinguishment of Debt,* and No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. This Statement amends FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* to clarify that a debt security may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. This Statement amends and extends to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* and supersedes FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*. This Statement also supersedes Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt,* No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs),* and No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*.

This Statement is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996, and is to be applied prospectively. Earlier or retroactive application is not permitted.

INTRODUCTION AND SCOPE

1. The Board added a project on financial instruments and off-balance-sheet financing to its agenda in May 1986. The project is intended to develop standards to aid in resolving existing financial accounting and reporting issues and other issues likely to arise in the future about various financial instruments and related transactions. The November 1991 FASB Discussion Memorandum, *Recognition and Measurement of Financial Instruments,* describes the issues to be considered. This Statement focuses on the issues of accounting for **transfers** [1] and servicing of **financial assets** and extinguishments of liabilities.

2. Transfers of financial assets take many forms. Accounting for transfers in which the **transferor** has no continuing involvement with the transferred assets or with the **transferee** has

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not been controversial. However, transfers of financial assets often occur in which the transferor has some continuing involvement either with the assets transferred or with the transferee. Examples of continuing involvement are **recourse**, servicing, agreements to reacquire, options written or held, and pledges of **collateral**. Transfers of financial assets with continuing involvement raise issues about the circumstances under which the transfers should be considered as sales of all or part of the assets or as secured borrowings and about how transferors and transferees should account for sales and secured borrowings. This Statement establishes standards for resolving those issues.

3. An entity may settle a liability by transferring assets to the creditor or otherwise obtaining an unconditional release. Alternatively, an entity may enter into other arrangements designed to set aside assets dedicated to eventually settling a liability. Accounting for those arrangements has raised issues about when a liability should be considered extinguished. This Statement establishes standards for resolving those issues.

4. This Statement does not address transfers of custody of financial assets for safekeeping, contributions, [2] or investments by owners or distributions to owners of a business enterprise. This Statement does not address subsequent measurement of assets and liabilities, except for (a) **servicing assets** and **servicing liabilities** and (b) **interest-only strips,** securities, loans, other receivables, or retained interests in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment. This Statement does not change the accounting for employee benefits subject to the provisions of FASB Statement No. 87, *Employers' Accounting for Pensions,* No. 88, *Employers' Accounting for Settlement and Curtailments of Defined Benefit Pension Plans and for Termination Benefits,* or No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* This Statement does not change the provisions relating to leveraged leases in FASB Statement No. 13, *Accounting for Leases,* or money-over-money and wrap lease transactions involving nonrecourse debt subject to the provisions of FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*. This Statement does not address transfers of nonfinancial assets, for example, servicing assets, or transfers of unrecognized financial assets, for example, minimum lease payments to be received under operating leases.

5. The Board concluded that an objective in accounting for transfers of financial assets is for each entity that is a party to the transaction to recognize only assets it controls and liabilities it has incurred, to **derecognize** assets only when control has been surrendered, and to derecognize liabilities only when they have been extinguished. Sales and other transfers frequently result in a disaggregation of financial assets and liabilities into components, which become separate assets and liabilities. For example, if an entity sells a portion of a financial asset it owns, the portion retained becomes an asset separate from the portion sold and from the assets obtained in exchange.

6. The Board concluded that another objective is that recognition of financial assets and liabilities should not be affected by the sequence of transactions that result in their acquisition or

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incurrence unless the effect of those transactions is to maintain effective control over a transferred financial asset. For example, if a transferor sells financial assets it owns and at the same time writes a put option (such as a guarantee or recourse obligation) on those assets, it should recognize the put obligation in the same manner as would another unrelated entity that writes an identical put option on assets it never owned. Similarly, a creditor may release a debtor on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable. In those circumstances, the original debtor becomes a guarantor and should recognize a guarantee obligation in the same manner as would a third-party guarantor that had never been primarily liable to that creditor, whether or not explicit consideration was paid for that guarantee. However, certain agreements to repurchase or redeem transferred assets maintain effective control over those assets and should therefore be accounted for differently than agreements to acquire assets never owned.

7. Previous accounting standards generally required that a transferor account for financial assets transferred as an inseparable unit that had been either entirely sold or entirely retained. Those standards were difficult to apply and produced inconsistent and arbitrary results. For example, whether a transfer "purported to be a sale" was sufficient to determine whether the transfer was accounted for and reported as a sale of receivables under one accounting standard or as a secured borrowing under another.

8. Previous standards did not accommodate recent innovations in the financial markets. After studying many of the complex developments that have occurred in financial markets during recent years, the Board concluded that previous approaches that viewed each financial asset as an indivisible unit do not provide an appropriate basis for developing consistent and operational standards for dealing with transfers and servicing of financial assets and extinguishments of liabilities. To address those issues adequately and consistently, the Board decided to adopt as the basis for this Statement a *financial-components approach* that focuses on control and recognizes that financial assets and liabilities can be divided into a variety of components.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than **beneficial interests** in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the

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reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).

b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.
c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).

10. Upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a **securitization** (paragraphs 47-58), and retained **undivided interests** (paragraph 33)
b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative **fair values** at the date of transfer (paragraphs 31-34).

11. Upon completion [3] of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (**seller**) shall:

a. Derecognize all assets sold
b. Recognize all assets obtained and liabilities incurred in consideration as **proceeds** of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)
c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)
d. Recognize in earnings any gain or loss on the sale.

The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

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Recognition and Measurement of Servicing Assets and Liabilities

13. Each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract, unless it securitizes the assets, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. A servicing asset or liability shall be amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value (paragraphs 35-38).

Financial Assets Subject to Prepayment

14. Interest-only strips, loans, other receivables, or retained interests in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended by this Statement (paragraph 233). [4]

Secured Borrowings and Collateral

15. A debtor may grant a **security interest** in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then
   (i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.
   (ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

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b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor's right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.
c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.
d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Extinguishments of Liabilities

16. A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. *Paying the creditor* includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.
b. The debtor is legally released [5] from being the primary obligor under the liability, either judicially or by the creditor.

Disclosures

17. An entity shall disclose the following:

a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security
b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, *Extinguishment of Debt,* prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding
c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets
d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value
e. For all servicing assets and servicing liabilities:
   (1) The amounts of servicing assets or liabilities recognized and amortized during the

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period

(2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value

(3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37

(4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

Implementation Guidance

18. Appendix A describes certain provisions of this Statement in more detail and describes their application to certain types of transactions. Appendix A is an integral part of the standards provided in this Statement.

Effective Date and Transition

19. This Statement shall be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996, and shall be applied prospectively. Earlier or retroactive application of this Statement is not permitted.

20. For each servicing contract in existence before January 1, 1997, previously recognized servicing rights and "excess servicing" receivables that do not exceed **contractually specified servicing fees** shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset or liability. Previously recognized servicing receivables that exceed contractually specified servicing fees shall be reclassified as interest-only strips receivable. Thereafter, the subsequent measurement provisions of this Statement shall be applied to the servicing assets or liabilities for those servicing contracts (paragraph 37) and to the interest-only strips receivable (paragraph 14).

21. The provisions of paragraph 14 and the amendment to Statement 115 (paragraph 233) shall be effective for financial assets held on or acquired after January 1, 1997.

The provisions of this Statement need
not be applied to immaterial items.

This Statement was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Foster dissented.

Mr. Foster dissents from the issuance of this Statement because he believes that the notion of effective control that is applied to repurchase agreements, including dollar rolls, and

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securities lending transactions should be applied consistently to other transfers of financial assets, including securitization transactions. Furthermore, he believes that in those instances where the financial-components approach is applied, all rights (assets) and obligations (liabilities) that are recognized by the transferor after a sale or securitization has occurred should be measured at fair value.

Under paragraphs 9(a) and 9(b) of this Statement, control is deemed to have been surrendered if the transferred assets have been legally isolated from the transferor and the transferee has the right to pledge or exchange the transferred assets. That notion of control is the cornerstone of the financial-components approach. However, the Board considered that approach inappropriate to account for certain transactions, such as those involving repurchase agreements, including dollar rolls, and securities lending transactions, where legal control over the assets has been surrendered, but where the Board believes that effective control still exists. For those transactions, paragraph 9(c) was specifically crafted to override the criteria for transfers of legal control in paragraphs 9(a) and 9(b). Paragraph 9(c), however, was designed to provide an exception only for certain transactions resulting in inconsistent application of the control notion: one set of transfers of financial assets—securitizations—is accounted for using a narrow, legal definition of control while others are accounted for using a broad notion of effective control. Mr. Foster favors an approach that encompasses the broader notion of effective control. He questions why, if the financial-components approach is inappropriate to account for all transfers of financial assets, it is appropriate to apply it to securitizations. He believes that if the entirety of the arrangement is considered, certain securitization transactions, such as those having a revolving-period agreement, also result in effective control being retained by the transferor and accordingly those transactions should be accounted for as secured borrowings.

In securitizations having a revolving-period agreement, which are described in paragraphs 130-133, the transferor generally continues to collect the cash from the transferred receivables, commingles that cash with its own cash, invests the cash for its own benefit, and uses the cash to buy additional receivables from itself that it selects. As a result of those features, the future benefits of the receivables (the cash flows to be received from them) that inure to the transferor are little different, if at all, from the future benefits that the transferor would obtain from receivables that it holds for its own account. Mr. Foster believes that in those transactions effective control of the receivables has not been surrendered and that the transferred receivables continue to be assets of the transferor.

Paragraph 26 of FASB Concepts Statement No. 6, *Elements of Financial Statements,* states, "An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred." Mr. Foster believes that in securitizations having revolving-period agreements, the transferred receivables meet each of those criteria from the perspective of the transferor. The transferred receivables directly or indirectly contribute to the transferor's cash inflows—it generally receives and retains all of the cash inflows during the term of the arrangement subject only to payment of what amounts to interest on the investment of the

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holders of beneficial interests—and the transferor can and does obtain and control others' access to both the receivables and the cash inflows by its structuring of the transaction and retention of most of the cash flows until termination of the arrangement. Paragraph 131 of this Statement asserts that the cash obtained by the transferor in those securitizations is received in exchange for new receivables and is not obtained as a benefit attributable to its previous ownership of the transferred receivables. In substance, however, the transfer of new receivables is little different from the substitution of collateral prevalent in many secured loan arrangements. In short, the transferred receivables have all of the attributes of assets controlled by the transferor.

As described below, the principal criteria cited in the basis for conclusions for treating repurchase agreements and securities lending transactions as secured borrowings apply equally to many securitizations, particularly those having a revolving-period agreement.

The inability of the transferor in a transfer with a revolving-period agreement to sell new receivables elsewhere because it has contracted to sell those new receivables on prearranged terms at times that it does not determine or have much influence over is asserted to be significant in paragraph 131. However, within fairly wide latitude, the transferor in those circumstances has retained the right to change the interest rate (the price) on both the previously transferred receivables and receivables to be transferred in the future. Mr. Foster believes that that right substantially diminishes any disadvantage of not being able to sell the receivables elsewhere and substantially negates any effect, favorable or onerous, on the transferor as a result of changes in market conditions as asserted in paragraph 50. In fact, any effects on the transferor result solely from having financed the receivables at whatever rate is paid the beneficial owners of the securities. Furthermore, the transferor of assets transferred under repurchase agreements or in securities lending transactions cannot sell those assets elsewhere.

Two reasons advanced in support of the treatment of repurchase agreements and securities lending transactions as secured borrowings are that (a) those transactions are difficult to characterize because they have attributes of both borrowings and sales and (b) supporting arguments can be found for accounting for those transactions as borrowings or sales. Those two reasons are equally applicable to securitization transactions having a revolving-period agreement—they are treated as sales for purposes of marketing to investors and as borrowings for tax purposes, and legal opinions and the prospectuses for those transactions acknowledge that their treatment as sales may not be sustained in a legal dispute.

The only supporting arguments cited for the treatment of repurchase agreements and securities lending transactions as secured borrowings that are not equally applicable to certain securitizations are that (a) forward contracts that are fully secured should be treated differently than those that are unsecured and (b) making a change in existing accounting practice would have a substantial impact on the reported financial position of certain entities and on the markets in which they participate. Mr. Foster does not believe that the existence of security in support of a transaction should determine its accounting treatment and notes that extension of the reasoning in paragraph 141 would lead to lenders not recognizing loans receivable that are unsecured. While it may be necessary to consider prior accounting treatment and the effect a change in accounting practice would have on certain entities, Mr. Foster believes that those factors should carry relatively little weight in determining what is an appropriate accounting standard.

Paragraph 18 of Opinion 29 states, "The Board concludes that in general accounting for

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nonmonetary transactions should be based on the fair values of the assets (or services) involved which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it . . . " (footnote reference omitted). The conclusion embodied in that language is that the accounting for both monetary and nonmonetary transactions acquired in an exchange should be based on the fair values of the assets (or services) involved. Mr. Foster believes that in securitization transactions in which control is deemed under this Statement to be surrendered and in partial sales of financial assets, assets (or rights) are surrendered in exchange for cash and other rights and obligations, all of which are new. [6] The new assets (rights) received are part of the proceeds of the exchange, and any liabilities (obligations) incurred are a reduction of the proceeds. As such, those new assets and liabilities should be measured at their fair values as they are in all other exchange transactions.

This Statement contends that in those transactions certain components of the original assets have not been exchanged. If that is one's view, however, it is clear that a transaction of sufficient significance to result in the derecognition of assets has occurred. Furthermore, the event of securitization results in a change in the form and value of assets—securities are generally more easily sold or used as collateral and thus are more valuable than receivables. Mr. Foster believes that a securitization transaction, like the initial recognition of an asset or liability and derecognition of assets and liabilities where it is clear an exchange has occurred, is also sufficiently significant that the resulting, or remaining components of, assets and liabilities should be recorded at fair value.

Mr. Foster also notes, as described in paragraphs 182-184, that the distinctions made in paragraphs 10 and 11 between (a) assets retained and (b) assets obtained and liabilities incurred are arbitrary. For example, one could easily argue that beneficial interests acquired in a transfer of receivables have different rights and obligations than the receivables and accordingly should be accounted for not as retained assets, but as new and different assets, and, arguably, the rights inherent in derivatives arising in a securitization transaction, which are considered new rights (assets) in this Statement, were embedded, albeit in an obscure form, in the transferred assets and could be as readily identified as retained portions of them. That the Board needed to make those distinctions arbitrarily begs for a consistent measurement attribute—fair value—for all of the rights and obligations held by the transferor subsequent to the transfer.

Members of the Financial Accounting Standards Board

Dennis R. Beresford, *Chairman*
Joseph V. Anania
Anthony T. Cope
John M. Foster
James J. Leisenring
Robert H. Northcutt
Robert J. Swieringa

Appendix A

IMPLEMENTATION GUIDANCE

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Appendix A: IMPLEMENTATION GUIDANCE

Introduction

22. This appendix describes certain provisions of this Statement in more detail and describes how they apply to certain types of transactions. This appendix discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this Statement. This appendix is an integral part of the standards provided in this Statement.

Isolation beyond the Reach of the Transferor and Its Creditors

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57(c)).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on

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sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Qualifying Special-Purpose Entity

26. A qualifying special-purpose entity [7] must meet both of the following conditions:

a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
   (1) Holding title to transferred financial assets
   (2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
   (3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
   (4) Distributing proceeds to the holders of its beneficial interests.
b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it." [8] In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same, [9] the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

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a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
b. Identical form and type so as to provide the same risks and rights
c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
d. Identical contractual interest rates
e. Similar assets as collateral
f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a **cleanup call**.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

31. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any **derivative financial instrument** entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Illustration—Recording Transfers with Proceeds of Cash, Derivatives, and Other Liabilities

32. Company A sells loans with a fair value of $1,100 and a carrying amount of $1,000. Company A retains no servicing responsibilities but obtains an option to purchase from the transferee the loans sold or similar loans and assumes a recourse obligation to repurchase delinquent loans. Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).

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Fair Values

Cash proceeds	$1,050
Interest rate swap	40
Call option	70
Recourse obligation	60

Net Proceeds

Cash received	$1,050
Plus: Call option	70
Interest rate swap	40
Less: Recourse obligation	(60)
Net proceeds	$1,100

Gain on Sale

Net proceeds	$1,100
Carrying amount of loans sold	1,000
Gain on sale	$ 100

Journal Entry

Cash	1,050	
Interest rate swap	40	
Call option	70	
Loans		1,000
Recourse obligation		60
Gain on sale		100
To record transfer		

Retained Interests

33. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 31.

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Illustration—Recording Transfers of Partial Interests

34. Company B sells a pro rata nine-tenths interest in loans with a fair value of $1,100 and a carrying amount of $1,000. There is no servicing asset or liability, because Company B estimates that the **benefits of servicing** are just adequate to compensate it for its servicing responsibilities.

Fair Values	
Cash proceeds for nine-tenths interest sold	$990
One-tenth interest retained [($990 ÷ 9/10) × 1/10]	110

Carrying Amount Based on Relative Fair Values

	Fair Value	**Percentage of Total Fair Value**	**Allocated Carrying Amount**
Nine-tenths interest sold	$ 990	90	$ 900
One-tenth interest retained	110	10	100
Total	$1,100	100	$1,000

Gain on Sale

Net proceeds	$990
Carrying amount of loans sold	900
Gain on sale	$ 90

Journal Entry

Cash	990	
Loans		900
Gain on sale		90
To record transfer		

Servicing Assets and Liabilities

35. Servicing of mortgage loans, credit card receivables, or other financial assets includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets. Servicing is inherent in all

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financial assets; it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing.

36. An entity that undertakes a contract to service financial assets shall recognize either a servicing asset or a servicing liability, unless the transferor securitizes the assets, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with Statement 115, in which case the servicing asset or liability may be reported together with the asset being serviced. Each sale or securitization with servicing retained or separate purchase or assumption of servicing results in a servicing contract. A servicer of financial assets commonly receives the benefits of servicing—revenues from contractually specified servicing fees, late charges, and other ancillary sources, including "float," all of which it is entitled to receive only if it performs the servicing—and incurs the costs of servicing the assets. Each servicing contract results in a servicing asset or servicing liability. Typically, the benefits of servicing are expected to be more than **adequate compensation** to the servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate the servicer for performing the servicing, the contract results in a servicing liability.

37. A servicer that recognizes a servicing asset or servicing liability shall account for the contract to service financial assets separately from those assets, as follows:

a. Report servicing assets separately from servicing liabilities in the statement of financial position (paragraph 13).
b. Initially measure servicing assets retained in a sale or securitization of the assets being serviced at their allocated previous carrying amount based on relative fair values, if practicable, at the date of the sale or securitization (paragraphs 10, 33, 34, and 42-46).
c. Initially measure servicing assets purchased or servicing liabilities assumed at fair value (paragraph 13).
d. Initially measure servicing liabilities undertaken in a sale or securitization at fair value, if practicable (paragraphs 11(b), 11(c), and 42-46).
e. Account separately for rights to future interest income from the serviced assets that exceeds contractually specified servicing fees. Those rights are not servicing assets; they are financial assets, effectively interest-only strips to be accounted for in accordance with paragraph 14 of this Statement.
f. Subsequently measure servicing assets by amortizing the amount recognized in proportion to and over the period of estimated net servicing income—the excess of servicing revenues over servicing costs (paragraph 13).
g. Subsequently evaluate and measure impairment of servicing assets as follows:
    (1) Stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets. Those characteristics may include financial asset type, **10** size, interest rate, date of origination, term, and geographic location.
    (2) Recognize impairment through a valuation allowance for an individual stratum. The

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amount of impairment recognized shall be the amount by which the carrying amount of servicing assets for a stratum exceeds their fair value. The fair value of servicing assets that have not been recognized shall not be used in the evaluation of impairment.

(3) Adjust the valuation allowance to reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. Fair value in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized. This Statement does not address when an entity should record a direct write-down of recognized servicing assets (paragraph 13).

h. Subsequently measure servicing liabilities by amortizing the amount recognized in proportion to and over the period of estimated net servicing loss—the excess of servicing costs over servicing revenues. However, if subsequent events have increased the fair value of the liability above the carrying amount, for example, because of significant changes in the amount or timing of actual or expected future cash flows from the cash flows previously projected, the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings (paragraph 13).

38. As indicated above, transferors sometimes agree to take on servicing responsibilities when the future benefits of servicing are not expected to adequately compensate them for performing that servicing. In that circumstance, the result is a servicing liability rather than a servicing asset. For example, if in the transaction illustrated in paragraph 32 the transferor had agreed to service the loans without explicit compensation and it estimated the fair value of that servicing obligation at $50, net proceeds would be reduced to $1,050, gain on sale would be reduced to $50, and the transferor would report a servicing liability of $50.

Illustration—Sale of Receivables with Servicing Retained

39. Company C originates $1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C sells the $1,000 principal plus the right to receive interest income of 8 percent to another entity for $1,000. Company C will continue to service the loans and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest income not sold is considered an interest-only strip receivable. At the date of the transfer, the fair value of the loans, including servicing, is $1,100. The fair value of the servicing asset is $40.

Fair Values	
Cash proceeds	$1,000
Servicing asset	40
Interest-only strip receivable	60

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Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage of Total Fair Value	Allocated Carrying Amount
Loans sold	$1,000	91	$910
Servicing asset	40	3.6	36
Interest-only strip receivable	60	5.4	54
Total	$1,100	100	$1,000

Gain on Sale	
Net proceeds	$1,000
Carrying amount of loans sold	910
Gain on sale	$ 90

Journal Entries

	Debit	Credit
Cash	1,000	
Loans		910
Gain on sale		90
To record transfer		
Servicing asset	36	
Interest-only strip receivable	54	
Loans		90
To record servicing asset and interest-only strip receivable		
Interest-only strip receivable	6	
Equity		6
To begin to subsequently measure interest-only strip receivable like an available-for-sale security (paragraph 14)		

40. The previous illustration demonstrates how a transferor would account for a simple sale or securitization in which servicing is retained. Company C might instead transfer the financial assets to a corporation or a trust that is a qualifying special-purpose entity. If the qualifying special-purpose entity securitizes the loans by selling beneficial interests to the public, it in turn becomes a transferor of securities to investors. The qualifying special-purpose entity pays the cash proceeds to the original transferor, which accounts for the transfer as a sale and derecognizes the financial assets assuming that the criteria in paragraph 9 are met. Securitizations often combine the elements shown in paragraphs 32, 34, and 39, as illustrated below.

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Illustration—Recording Transfers of Partial Interests with Proceeds of Cash, Derivatives, Other Liabilities, and Servicing

41. Company D originates $1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8 percent to another entity. Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D retains an option to purchase the loans sold or similar loans and a recourse obligation to repurchase delinquent loans.

Fair Values

Cash proceeds	$900
Call option	70
Recourse obligation	60
Servicing asset	90
One-tenth interest retained	100

Net Proceeds

Cash received	$900
Plus: Call option	70
Less: Recourse obligation	(60)
Net proceeds	$910

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage of Total Fair Value	Allocated Carrying Amount
Interest sold	$ 910	83	$ 830
Servicing asset	90	8	80
One-tenth interest retained	100	9	90
Total	$1,100	100	$1,000

Gain on Sale

Net proceeds	$910
Carrying amount of loans sold	830
Gain on sale	$ 80

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Journal Entries

Cash	900	
Call option	70	
Loans		830
Recourse obligation		60
Gain on sale		80
To record transfer		
Servicing asset	80	
Loans		80
To record servicing asset		

At the time of the transfer, Company D reports its one-tenth retained interest in the loans at its allocated carrying amount of $90.

Fair Value

42. The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price.

43. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring **financial liabilities** and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.

44. Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight

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given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

If It Is Not Practicable to Estimate Fair Values

45. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

a. The excess, if any, of (1) the fair values of assets obtained less the fair values of other liabilities incurred, over (2) the sum of the carrying values of the assets transferred
b. The amount that would be recognized in accordance with FASB Statement No. 5, *Accounting for Contingencies,* as interpreted by FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*.

Illustration—Recording Transfers If It Is Not Practicable to Estimate a Fair Value

46. Company E sells loans with a carrying amount of $1,000 to another entity for cash plus a call option to repurchase the loans sold or similar loans and incurs a recourse obligation to repurchase any delinquent loans. Company E undertakes to service the transferred assets for the other entity. In Case 1, Company E finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate compensation for performing the servicing. In Case 2, Company E finds it impracticable to estimate the fair value of the recourse obligation.

Fair Values	Case 1	Case 2
Cash proceeds	$1,050	$1,050
Servicing asset	XX*	40
Call option	70	70
Recourse obligation	60	XX*
Fair value of loans transferred	1,100	1,100

*Not practicable to estimate fair value.

Net Proceeds	Case 1	Case 2
Cash received	$1,050	$1,050
Plus: Call option	70	70

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Less: Recourse obligation	(60)	XX
Net proceeds	$1,060	$1,120

Carrying Amount Based on Relative Fair Values (Case 1)

	Fair Value	Percentage of Total Fair Value	Allocated Carrying Amount
Loans sold	$1,060	100	$1,000
Servicing asset	0	0	0
Total	$1,060	100	$1,000

Carrying Amount Based on Relative Fair Values (Case 2)

	Fair Value	Percentage of Total Fair Value	Allocated Carrying Amount
Loans sold	$1,120	97	$ 970
Servicing asset	40	3	30
Total	$1,160	100	$1,000

Journal Entries	**Case 1**		**Case 2**	
Cash	1,050		1,050	
Servicing asset	0*		30	
Call option	70		70	
Loans		1,000		1,000
Recourse obligation		60		150†
Gain on sale		60		0
To record transfer				

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*Assets shall be recorded at zero if an estimate of the fair value of the assets is not practicable.

†The amount recorded as a liability in this example equals the sum of the known assets less the fair value of the known liabilities, that is, the amount that results in no gain or loss.

Securitizations

47. Financial assets such as mortgage loans, automobile loans, trade receivables, credit card receivables, and other revolving charge accounts are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential

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mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Securitizations of loans secured by chattel mortgages on automotive vehicles as well as other equipment (including direct financing or sales-type leases) also are common. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties, and even taxi medallions also have been securitized. But securitizations of nonfinancial assets are outside the scope of this Statement.

48. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to a special-purpose entity, commonly a trust. In "pass-through" and "pay-through" securitizations, receivables are transferred to the special-purpose entity at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the special-purpose entity. In "revolving-period" securitizations, receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the special-purpose entity uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.

49. Beneficial interests in the qualifying special-purpose entity are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the qualifying special-purpose entity.

50. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 9 qualify for sale accounting under this Statement. All financial assets obtained or retained and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 11; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Revolving-Period Securitizations

51. The value of the forward contract implicit in a revolving-period securitization arises from the difference between the agreed-upon rate of return to investors on their beneficial interests in the trust and current market rates of return on similar investments. For example, if the agreed-upon annual rate of return to investors in a trust is 6 percent, and later market rates of return for those investments increased to 7 percent, the forward contract's value to the transferor (and burden to the investors) would approximate the present value of 1 percent of the amount of the investment for each year remaining in the revolving structure after the receivables already transferred have been collected. If a forward contract to sell receivables is entered into at the market rate, its value at inception may be zero. Changes in the fair value of the forward contract

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are likely to be greater if the investors receive a fixed rate than if the investors receive a rate that varies based on changes in market rates.

52. Gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold. Recognition of servicing assets or liabilities for revolving-period receivables is similarly limited to the servicing for the receivables that exist and have been transferred. As new receivables are sold, rights to service them become assets or liabilities and are recognized.

53. Revolving-period securitizations may use either a discrete trust, used for a single securitization, or a master trust, used for many securitizations. To achieve another securitization using an existing master trust, a transferor first transfers additional receivables to the trust and then sells additional ownership interests in the trust to investors. Adding receivables to a master trust, in itself, is neither a sale nor a secured borrowing under paragraph 9, because that transfer only increases the transferor's beneficial interest in the trust's assets. A sale does not occur until the transferor receives consideration other than beneficial interests in the transferred assets. Transfers that result in an exchange of cash, that is, either transfers that in essence replace previously transferred receivables that have been collected or sales of beneficial interests to outside investors, are transfers in exchange for consideration other than beneficial interests in the transferred assets and thus are accounted for as sales (if they satisfy all the criteria in paragraph 9) or as secured borrowings.

Isolation of Transferred Assets in Securitizations

54. A securitization, carried out in one transfer or a series of transfers, may or may not isolate the transferred assets beyond the reach of the transferor and its creditors. Whether it does depends on the structure of the securitization transaction taken as a whole, considering such factors as the type and extent of further involvement in arrangements to protect investors from credit and interest rate risks, the availability of other assets, and the powers of bankruptcy courts or other receivers.

55. In certain securitizations, a corporation that, if it failed, would be subject to the U.S. Bankruptcy Code transfers financial assets to a special-purpose trust in exchange for cash. The trust raises that cash by issuing to investors beneficial interests that pass through all cash received from the financial assets, and the transferor has no further involvement with the trust or the transferred assets. The Board understands that those securitizations generally would be judged as having isolated the assets, because in the absence of any continuing involvement there would be reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

56. In other securitizations, a similar corporation transfers financial assets to a special-purpose entity in exchange for cash and beneficial interests in the transferred assets. That entity raises the cash by issuing to investors commercial paper that gives them a senior interest in cash

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received from the financial assets. The beneficial interests retained by the transferring corporation represent a junior interest to be reduced by any credit losses on the financial assets in trust. The commercial paper interests are highly rated by credit rating agencies largely because the transferor is highly rated. Depending on facts and circumstances, the Board understands that those “single-step” securitizations often would be judged in the United States as not having isolated the assets, because the nature of the continuing involvement may make it difficult to obtain reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors in U.S. bankruptcy (paragraph 83). If the transferor fell into bankruptcy and the transfer was found not to be a true sale at law, investors in the transferred assets might be subjected to an automatic stay that would delay payments due them, and they might have to share in bankruptcy expenses and suffer further losses if the transfer was recharacterized as a secured loan.

57. Still other securitizations use two transfers intended to isolate transferred assets beyond the reach of the transferor and its creditors, even in bankruptcy. In those “two-step” structures:

a. First, the corporation transfers financial assets to a special-purpose corporation that, although wholly owned, is so designed that the possibility that the transferor or its creditors could reclaim the assets is remote. This first transfer is designed to be judged to be a true sale at law, in part because the transferor does not provide “excessive” credit or yield protection to the special-purpose corporation, and the Board understands that transferred assets are likely to be judged beyond the reach of the transferor or the transferor's creditors even in bankruptcy.
b. Second, the special-purpose corporation transfers the assets to a trust, with a sufficient increase in the credit or yield protection on the second transfer (provided by a junior retained beneficial interest or other means) to merit the high credit rating sought by third-party investors who buy senior beneficial interests in the trust. Because of that aspect of its design, that second transfer might not be judged to be a true sale at law and, thus, the transferred assets could at least in theory be reached by a bankruptcy trustee for the special-purpose corporation.
c. However, the special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of its parent should that occur. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if it somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred assets because it has no other assets to substitute for the transferred assets.

The Board understands that the "two-step" securitizations described above, taken as a whole, generally would be judged under present U.S. law as having isolated the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

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58. A securitization by an entity subject to a possible receivership under procedures different from the U.S. Bankruptcy Code may isolate transferred assets from the transferor and its creditors even though it uses only one transfer directly to a special-purpose entity that issues beneficial interests to investors and the transferor provides credit or yield protection. For example, the Board understands that assets transferred by a U.S. bank are not subject to an automatic stay under Federal Deposit Insurance Corporation (FDIC) receivership and could only be obtained by the receiver if it makes the investors completely whole, that is, the investors must be paid compensation equivalent to all the economic benefits contained in the transferred assets, including bargained-for yield, before the FDIC could obtain those assets. Those limited powers appear insufficient to place the transferred assets within reach of the receiver. The powers of other receivers for entities not subject to the U.S. Bankruptcy Code, and of bankruptcy trustees in other jurisdictions, vary considerably, and therefore some receivers may be able to reach transferred financial assets, and others may not.

Sales-Type and Direct Financing Lease Receivables

59. Sales-type and direct financing receivables secured by leased equipment, referred to as gross investment in lease receivables, are made up of two components: minimum lease payments and residual values. Minimum lease payments are requirements for lessees to pay cash to lessors and meet the definition of a financial asset. Thus, transfers of minimum lease payments are subject to the requirements of this Statement. Residual values represent the lessor's estimate of the "salvage" value of the leased equipment at the end of the lease term and may be either guaranteed or unguaranteed; they meet the definition of financial assets *if they are guaranteed*. Thus, transfers of guaranteed residual values also are subject to the requirements of this Statement. Unguaranteed residual values do not meet the definition of financial assets, and transfers of them are not subject to the requirements of this Statement. Transfers of unguaranteed residual values continue to be subject to Statement 13, as amended. Because guaranteed residual value interests are treated as financial assets, increases to their estimated value over the life of the related lease are recognized. Entities selling or securitizing lease financing receivables shall allocate the gross investment in receivables between minimum lease payments and unguaranteed residual values using the individual carrying amounts of those components at the date of transfer. Entities also shall record a servicing asset or liability in accordance with paragraphs 10 and 13, if appropriate.

Illustration—Recording Transfers of Lease Financing Receivables with Residual Values

60. At the beginning of the second year in a 10-year sales-type lease, Company F sells for $505 a nine-tenths interest in the minimum lease payments and retains a one-tenth interest in the minimum lease payments and a 100 percent interest in the unguaranteed residual value of leased equipment. Company F receives no explicit compensation for servicing, but estimates that the other benefits of servicing are just adequate to compensate it for its servicing responsibilities and hence records no servicing an asset or liability. The carrying amounts and related gain computation are as follows:

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Carrying Amounts

Minimum lease payments		$ 540
Unearned income related to minimum lease payments		370
Gross investment in minimum lease payments		910
Unguaranteed residual value	$ 30	
Unearned income related to residual value	60	
Gross investment in residual value		90
Total gross investment in financing lease receivable		$1,000

Gain on Sale

Cash received		$ 505
Nine-tenths of carrying amount of gross investment in minimum lease payments	$819	
Nine-tenths of carrying amount of unearned income related to minimum lease payments	333	
Net carrying amount of minimum lease payments sold		486
Gain on sale		$ 19

Journal Entry

Cash	505	
Unearned income	333	
Lease receivable		819
Gain on sale		19

To record sale of nine-tenths of the minimum lease payments at the beginning of year 2

Securities Lending Transactions

61. Securities lending transactions are initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Transferees ("borrowers") of securities generally are required to provide "collateral" to the transferor ("lender") of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities "borrowed." If the "collateral" is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or "rebated" to the transferee. If the "collateral" is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of "collateral" (typically valued daily and adjusted frequently for changes in the market price of the

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securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash "collateral" impose market and credit risks on the transferor.

62. In some securities lending transactions, the criteria in paragraph 9 are met, including the third criterion. Those transactions shall be accounted for (a) by the transferor as a sale of the "loaned" securities for proceeds consisting of the "collateral" [11] and a forward repurchase commitment and (b) by the transferee as a purchase of the "borrowed" securities in exchange for the "collateral" and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

63. However, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 27-30). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed, and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported in the statement of financial position like other collateral, as set forth in paragraph 15.

64. The transferor of securities being “loaned” accounts for cash received (or for securities received that may be sold or repledged and were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract) in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash (or securities) received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash (or securities).

Illustration—Securities Lending Transaction Treated as a Secured Borrowing

65. Accounting for a securities lending transaction treated as a secured borrowing:

Facts

Transferor’s carrying amount and fair value of security loaned	$1,000
Cash "collateral"	1,020

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Transferor's return from investing cash collateral at a 5 percent annual rate	5
Transferor's rebate to the borrower at a 4 percent annual rate	4

The loaned securities cannot be redeemed on short notice, for example, by substitution of other collateral. For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

Journal Entries for the Transferor

At inception:

Cash	1,020	
Payable under securities loan agreements		1,020
To record the receipt of cash collateral		
Securities loaned to broker	1,000	
Securities		1,000
To reclassify loaned securities that cannot be redeemed on short notice		
Money market instrument	1,020	
Cash		1,020
To record investment of cash collateral		

At conclusion:

Cash	1,025	
Interest		5
Money market instrument		1,020
To record results of investment		
Securities	1,000	
Securities loaned to broker		1,000
To record return of security		
Payable under securities loan agreements	1,020	
Interest ("rebate")	4	
Cash		1,024
To record repayment of cash collateral plus interest		

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Journal Entries for the Transferee

At inception:

Receivable under securities loan agreements	1,020	
Cash		1,020
To record transfer of cash collateral		
Securities	1,000	
Obligation to return borrowed securities		1,000
To record receipt of borrowed securities that cannot be redeemed on short notice		

At conclusion:

Obligation to return borrowed securities	1,000	
Securities		1,000
To record the return of securities		
Cash	1,024	
Receivable under securities loan agreements		1,020
Interest revenue ("rebate")		4
To record the receipt of cash collateral and rebate interest		

Repurchase Agreements and "Wash Sales"

66. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash [12] and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest" factor.

67. Repurchase agreements can be effected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the

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arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

68. If the criteria in paragraph 9 are met, including the third criterion, the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

69. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

70. As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 9 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 28) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

71. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the term of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets. In those circumstances, the transferee does not acquire the right to sell or repledge the securities during the term of the repurchase agreement; therefore, it does not have access to the benefits embodied in those assets. The transferee shall not record those assets as its own, nor shall the transferor derecognize those assets.

Loan Syndications

72. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

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73. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender that then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is simply functioning as a servicer and, therefore, shall not recognize the aggregate loan as an asset.

Loan Participations

74. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.

75. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor ("originating lender") continues to service the loan. The transferee ("participating entity") may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.

76. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 9 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor is a limitation on the transferee's rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor has not relinquished control over the loan and shall account for the transfers as secured borrowings.

Banker's Acceptances and Risk Participations in Them

77. Banker's acceptances provide a way for a bank to finance a customer's purchase of goods from a vendor for periods usually not exceeding six months. Under an agreement between the bank, the customer, and the vendor, the bank agrees to pay the customer's liability to the vendor upon presentation of specified documents that provide evidence of delivery and acceptance of the purchased goods. The principal document is a draft or bill of exchange drawn by the customer that the bank stamps to signify its "acceptance" of the liability to make payment on the draft on its due date.

78. Once the bank accepts a draft, the customer is liable to repay the bank at the time the draft matures. The bank recognizes a receivable from the customer and a liability for the acceptance it has issued to the vendor. The accepted draft becomes a negotiable financial instrument. The vendor typically sells the accepted draft at a discount either to the accepting bank or in the marketplace.

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79. A risk participation is a contract between the accepting bank and a participating bank in which the participating bank agrees, in exchange for a fee, to reimburse the accepting bank in the event that the accepting bank's customer fails to honor its liability to the accepting bank in connection with the banker's acceptance. The participating bank becomes a guarantor of the credit of the accepting bank's customer.

80. An accepting bank that obtains a risk participation shall not derecognize the liability for the banker's acceptance because the accepting bank is still primarily liable to the holder of the banker's acceptance even though it benefits from a guarantee of reimbursement by a participating bank. The accepting bank shall not derecognize the receivable from the customer because it controls the benefits inherent in that receivable and it is still entitled to receive payment from the customer. The accepting bank shall, however, record the guarantee purchased, and the participating bank shall record a liability for the guarantee issued.

Illustration—Banker's Acceptance with a Risk Participation

81. An accepting bank assumes a liability to pay a customer's vendor and obtains a risk participation from another bank. The details of the banker's acceptance are provided below:

<u>Facts</u>

Face value of the draft provided to vendor	$1,000
Term of the draft provided to vendor	90 days
Commission with an annual rate of 10 percent	25
Fee paid for risk participation	10

<u>Journal Entries for Accepting Bank</u>

At issuance of acceptance:

Receivable from customer	1,000	
Cash	25	
Time draft payable to vendor		1,000
Deferred acceptance commission revenue		25

At purchase of risk participation from a participating bank:

Guarantee purchased	10	
Cash		10

Upon presentation of the accepted time draft:

Time draft payable to vendor	1,000	

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Deferred acceptance commission revenue	25	
Cash		1,000
Acceptance commission revenue		25

Upon collection from the customer (or the participating bank, if the customer defaults):

Cash	1,000	
Guarantee expense	10	
Receivable from customer		1,000
Guarantee purchased		10

Journal Entries for Participating Bank

Upon issuing the risk participation:

Cash	10	
Guarantee liability		10

Upon payment by the customer to the accepting bank:

Guarantee liability	10	
Guarantee revenue		10

OR:

In the event of total default by the customer:

Guarantee loss	990	
Guarantee liability	10	
Cash (paid to accepting bank)		1,000

Factoring Arrangements

82. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 9 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

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Transfers of Receivables with Recourse

83. In a transfer of receivables with recourse, the transferor provides the transferee with full or limited recourse. The transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. The effect of a recourse provision on the application of paragraph 9 may vary by jurisdiction. In some jurisdictions, transfers with full recourse may not place transferred assets beyond the reach of the transferor and its creditors, but transfers with limited recourse may. A transfer of receivables with recourse shall be accounted for as a sale, with the proceeds of the sale reduced by the fair value of the recourse obligation, if the criteria in paragraph 9 are met. Otherwise, a transfer of receivables with recourse shall be accounted for as a secured borrowing.

Extinguishments of Liabilities

84. If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.

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Appendix B

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix B: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

85. This appendix summarizes considerations that were deemed significant by Board members in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background

86. In recent years, transfers of financial assets in which the transferor has some continuing involvement with the transferred assets or with the transferee have grown in volume, variety, and complexity. Those transfers raise the issues of whether transferred financial assets should be considered to be sold and a related gain or loss recorded, whether the assets should be considered to be collateral for borrowings, or whether the transfer should not be recognized.

87. A transferor may sell financial assets and receive in exchange cash or other assets that are unrelated to the assets sold so that the transferor has no continuing involvement with the assets sold. Alternatively, an entity may borrow money and pledge financial assets as collateral, or a transferor may engage in any of a variety of transactions that transfer financial assets to another entity with the transferor having some continuing involvement with the assets transferred. Examples of continuing involvement are recourse or guarantee obligations, servicing, agreements to repurchase or redeem, and put or call options on the assets transferred.

88. Many transactions disaggregate financial assets into separate components by creating undivided interests in pools of financial assets that frequently reflect multiple participations (often referred to as tranches) in a single pool. The components created may later be recombined to restore the original assets or may be combined with other financial assets to create still different assets.

89. An entity also may enter into transactions that change the characteristics of an asset that the entity continues to hold. An entity may sell part of an asset, or an undivided interest in the asset, and retain part of the asset. In some cases, it has not been clear what the accounting should be.

90. An entity may settle a liability by transferring assets to a creditor and obtaining an unconditional release from the obligation. Alternatively, an entity may arrange for others to settle or set aside assets to settle a liability later. Those alternative arrangements have raised

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issues about when a liability is extinguished.

91. The Board previously provided guidance for two specific types of transfers of financial assets in FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse,* and in FASB Technical Bulletin No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*. Confusion and inconsistency in accounting practices developed because the provisions of those two pronouncements provided seemingly conflicting guidance. In practice, if an entity sold financial assets to a special-purpose entity that issued debt securities, the guidance under Technical Bulletin 85-2 would be applied, and if any of those securities were obtained by the seller, the transaction would be accounted for as a borrowing. However, if the interests issued by the special-purpose entity were designated as participations instead of debt securities, the guidance in Statement 77 would be applied, and the transaction would be accounted for as a sale even if the seller retained recourse on some of the participations. Further, accounting for other types of transfers, whether developed by analogy to Statement 77 or Technical Bulletin 85-2, in industry practices codified in various AICPA audit and accounting Guides, in consensuses of the Emerging Issues Task Force (EITF), or in other ways, added to the confusion and inconsistency.

92. FASB Statement No. 76, *Extinguishment of Debt,* established accounting practices that (a) treat liabilities that are not fully settled as if they had been extinguished and (b) derecognize assets transferred to a trust even though the assets continue to benefit the transferor. Some criticized Statement 76 as being inconsistent with Statement 77; others disagreed.

93. The Board decided that it was necessary to reconsider Statements 76 and 77, Technical Bulletin 85-2, and other guidance and to develop new standards for transfers of financial assets and extinguishments of liabilities.

94. The Board added a project to its agenda in May 1986 to address those and other problems in accounting for financial instruments and off-balance-sheet financing. This Statement, as part of that project, focuses on accounting for transfers and servicing of financial assets and extinguishments of liabilities. The Financial Instruments Task Force, which was formed in January 1989, assisted in the preparation of a Discussion Memorandum on those issues and advised the Board in its deliberations. The FASB Discussion Memorandum, *Recognition and Measurement of Financial Instruments,* was issued in November 1991. The Board received 96 comment letters on the Discussion Memorandum. During 1994 and 1995, the Board discussed issues about transfers and servicing of financial assets and extinguishments of liabilities at numerous public meetings. The Financial Instruments Task Force reviewed drafts of the proposed Statement and discussed it with the Board at a public meeting in February 1995. The Financial Accounting Standards Advisory Council discussed a draft of the proposed Statement and advised the Board at public meetings. The Board also received requests from constituents to discuss issues about credit card securitizations and securities lending transactions and repurchase agreements. The Board met with constituents interested in those issues at public meetings in November 1994 and April 1995.

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95. In October 1995, the Board issued an Exposure Draft, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* The Board received 112 comment letters on the Exposure Draft, and 24 individuals and organizations presented their views at a public hearing held in February 1996. In addition, 10 enterprises participated in limited field-testing of the provisions of the Exposure Draft. The comments and test results were considered by the Board during its redeliberations of the issues addressed by the Exposure Draft in public meetings in 1996. The Financial Instruments Task Force reviewed a draft of the final Statement. This Statement is a result of those Board meetings and deliberations.

Benefits and Costs

96. The Board's mission statement charges the Board to determine that a proposed standard will fill a significant need and that the costs it imposes will be justified in relation to the overall benefits.

97. Previous practices in accounting for transfers of financial assets were inconsistent about the circumstances that distinguish sales from secured borrowings. The result was confusion on the part of both users and preparers of financial statements. This Statement eliminates that inconsistency and should reduce that confusion by distinguishing sales from secured borrowings based on the underlying contractual commitments and customs that determine substance. Much of the information needed to implement the accounting required by this Statement is substantially the same as that required for previous accounting and, therefore, should be available. Some of the information may not have been collected in accounting systems but is commonly obtained by sellers and buyers for use in negotiating transactions. Although there will be one-time costs for systems changes needed to apply the accounting required by this Statement, the benefits in terms of more credible, consistent, and understandable information will be ongoing.

98. In addition, in developing this Statement, the Board considered how the costs incurred to implement the requirements of this Statement could be minimized by, for example, (a) not requiring retroactive application of the initial measurement provisions of this Statement to existing servicing rights and excess servicing receivables, (b) carrying over without change the subsequent measurement (amortization and impairment) provisions of FASB Statement No. 122, *Accounting for Mortgage Servicing Rights,* which mortgage servicers have recently implemented, (c) not requiring allocation of previous carrying amounts of assets partially sold based on relative fair values at acquisition, but rather at the date of transfer, and (d) not requiring additional disclosures for transfers such as securitizations beyond those currently presented within the financial statements. The Board is confident that the benefits derived from the accounting required by this Statement will outweigh the costs of implementation.

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Approaches Considered

99. The Board noted that the most difficult questions about accounting for transfers of financial assets concern the circumstances in which it is appropriate to remove previously recognized financial assets from the statement of financial position and to recognize gain or loss. One familiar approach to those questions views each financial asset as a unit that should not be derecognized until the risks and rewards that are embodied in that asset have been surrendered. Variations on that approach attempt to choose which risks and rewards are most critical and whether all or some major portion of those risks and rewards must be surrendered to allow derecognition.

100. In addition to reviewing U.S. accounting literature, the Board reviewed the approach described by the International Accounting Standards Committee (IASC) in its Proposed International Accounting Standard, *Financial Instruments,* Exposure Draft E40 (1992), later revised as Exposure Draft E48 (1994). In E40, derecognition of financial assets and liabilities would have been permitted only upon the transfer to others of the underlying risks and rewards, presumably all risks and rewards. That approach could have resulted in an entity's continuing to recognize assets even though it had surrendered control over the assets to a successor entity. The approach in E40 was similar to that taken in Technical Bulletin 85-2. The Board concluded that the approaches proposed in E40 and provided in Technical Bulletin 85-2 were unsatisfactory because the result does not faithfully represent the effects of the transfer of assets and because of the potential for inconsistencies.

101. In response to comments received on E40, the IASC proposal was revised in E48 to require the transfer of *substantially all* risks and rewards. That modification did not overcome the inconsistency noted in paragraphs 97 and 100 of this Statement and added the prospect of difficulties in application because of the need to identify, measure, and weigh in the balance each of possibly many and varied risks and rewards embodied in a particular financial asset. The number of different risks and rewards would vary depending on the definitions used. Questions would arise about whether each identified risk and reward should be substantially surrendered to allow derecognition, whether all risks should be aggregated separately from all rewards, and whether risks and rewards should somehow be offset and then combined for evaluation. That modification also might lead to wide variations in practice depending on how various entities interpreted *substantially all* in the necessarily subjective evaluation of the aggregated, offset, and combined risks and rewards. Moreover, viewing each financial asset as an indivisible unit is contrary to the growing practice in financial markets of disaggregating individual financial assets or pools of financial assets into components. The IASC is continuing to study that issue in its financial instruments project.

102. The Board also noted that application of a risks-and-rewards approach for derecognizing financial assets would be highly dependent on the sequence of transactions leading to their acquisition. For example, if Entity A initially acquired an undivided subordinated interest in a

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pool of financial assets, it would recognize that subordinated interest as a single asset. If, on the other hand, Entity B initially acquired a pool of financial assets identical to the pool in which Entity A participates, then sold a senior interest in the pool and continued to hold a subordinated interest identical to the undivided interest held by Entity A, Entity B might be judged under a risks-and-rewards approach to have retained substantially all the risks of the entire pool. Thus, Entity B would carry in its statement of financial position the entire pool of financial assets as well as an obligation equal to the proceeds from the sale of the undivided senior interest, while Entity A would report its identical position quite differently. Those accounting results would disregard one of the fundamental tenets of the Board's conceptual framework; that is, "accountants must not disguise real differences nor create false differences." [13]

103. The Board also considered the approach required by the United Kingdom's Accounting Standards Board in Financial Reporting Standard No. 5, *Reporting the Substance of Transactions,* a variation of the risks-and-rewards approach that requires the surrender of substantially all risks and rewards for derecognition of financial assets but permits, in limited circumstances, the use of a *linked presentation*. Use of the linked presentation is restricted to circumstances in which an entity borrows funds to be repaid from the proceeds of pledged financial assets, any excess proceeds go to the borrower, and the lender has no recourse to other assets of the borrower. In those circumstances, the pledged assets remain on the borrower's statement of financial position, but the unpaid borrowing is reported as a deduction from the pledged assets rather than as a liability; no gain or loss is recognized. That approach had some appeal to the Board because it would have highlighted significant information about transactions that many believe have characteristics of both sales and secured borrowings. The Board observed, however, that the linked presentation would not have dealt with many of the problems created by the risks-and-rewards approach. Further, the Board concluded that it is not appropriate for an entity to offset restricted assets against a liability or to derecognize a liability merely because assets are dedicated to its repayment, as discussed in paragraphs 218-221.

104. Statement 77 based the determination of whether to derecognize receivables on transfer of control instead of on evaluation of risks and rewards. This Statement takes a similar approach. However, Statement 77 was narrowly focused on sales of receivables with recourse and did not address other transfers of financial assets. Also, the derecognition of receivables under that Statement could depend on the sequence of transactions that led to their acquisition or on whether any options were involved. The Board concluded that simply superseding Technical Bulletin 85-2 and allowing Statement 77 to remain in effect would not have dealt adequately with the issues about transfers of financial assets.

105. Statement 76 followed a risks-and-rewards approach in requiring that (a) it be probable that a debtor would not be required to make future payments with respect to the debt under any guarantees and (b) an in-substance defeasance trust be restricted to owning only monetary assets that are risk free with cash flows that approximately coincide, as to timing and amount, with the scheduled interest and principal payments on the debt being extinguished. The Board concluded (paragraphs 218-221) that that approach was inconsistent with the financial-components

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approach that focuses on control developed in this Statement. As a result, the Board decided to supersede Statement 76 but to carry forward those of its criteria that could be modified to conform to the financial-components approach.

106. The considerations discussed in paragraphs 99-105 led the Board to seek an alternative to the risks-and-rewards approach and variations to that approach.

Objectives of the Financial-Components Approach

107. The Board concluded that it was necessary to develop an approach that would be responsive to current developments in the financial markets to achieve consistent accounting for transfers and servicing of financial assets and extinguishments of liabilities. That approach—the financial-components approach—is designed to:

a. Be consistent with the way participants in the financial markets deal with financial assets, including the combination and separation of components of those assets
b. Reflect the economic consequences of contractual provisions underlying financial assets and liabilities
c. Conform to the FASB conceptual framework.

108. The approach analyzes a transfer of a financial asset by examining the component assets (controlled economic benefits) and liabilities (obligations for probable future sacrifices of economic benefits) that exist after the transfer. Each party to the transfer recognizes the assets and liabilities that it controls after the transfer and no longer recognizes the assets and liabilities that were surrendered or extinguished in the transfer. That approach has some antecedents in existing accounting guidance, for example, in EITF Issue No. 88-11, "Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold." The Board identified the concepts set forth in paragraphs 109-111 as an appropriate basis for the financial-components approach.

Conceptual Basis for the Financial-Components Approach

109. FASB Concepts Statement No. 6, *Elements of Financial Statements,* states the following about assets:

> Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [Paragraph 25, footnote reference omitted.]
>
> *Every asset is an asset of some entity; moreover, no asset can simultaneously be an asset of more than one entity,* although a particular physical thing or other agent [e.g., contractual rights and obligations] that provides future economic benefit may provide separate benefits to two or more entities at the same time. . . . To have an asset, an entity must control future economic benefit to the extent that it can benefit from the asset and generally can deny or regulate access to that

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benefit by others, for example, by permitting access only at a price.

Thus, *an asset of an entity is the future economic benefit that the entity can control and thus can, within limits set by the nature of the benefit or the entity's right to it, use as it pleases*. The entity having an asset is the one that can exchange it, use it to produce goods or services, exact a price for others' use of it, use it to settle liabilities, hold it, or perhaps distribute it to owners.

The definition of assets focuses primarily on the future economic benefit to which an entity has access and only secondarily on the physical things and other agents that provide future economic benefits. *Many physical things and other agents are in effect bundles of future economic benefits that can be unbundled in various ways, and two or more entities may have different future economic benefits from the same agent at the same time or the same continuing future economic benefit at different times.* For example, two or more entities may have undivided interests in a parcel of land. Each has a right to future economic benefit that may qualify as an asset under the definition in paragraph 25, even though the right of each is subject at least to some extent to the rights of the other(s). Or, one entity may have the right to the interest from an investment, while another has the right to the principal. [Paragraphs 183-185; emphasis added.]

110. Concepts Statement 6 states the following about liabilities:

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [Paragraph 35, footnote references omitted.]

Most liabilities are obligations of only one entity at a time. Some liabilities are shared—for example, two or more entities may be "jointly and severally liable" for a debt or for the unsatisfied liabilities of a partnership. But most liabilities bind a single entity, and those that bind two or more entities are commonly ranked rather than shared. For example, *a primary debtor and a guarantor may both be obligated for a debt, but they do not have the same obligation—the guarantor must pay only if the primary debtor defaults and thus has a contingent or secondary obligation,* which ranks lower than that of the primary debtor.

Secondary, and perhaps even lower ranked, obligations may qualify as liabilities under the definition in paragraph 35, but recognition considerations are highly significant in deciding whether they should formally be included in financial statements because of the effects of uncertainty (paragraphs 44-48). For example, the probability that a secondary or lower ranked obligation will actually have to be paid must be assessed to apply the definition. [Paragraphs 204 and 205; emphasis added.]

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111. Financial assets and liabilities are assets and liabilities that qualify as financial instruments as defined in paragraph 3 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments:*

> A financial instrument is defined as cash, evidence of an ownership interest in an entity, or a contract that both:
>
> a. Imposes on one entity a contractual obligation (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity
> b. Conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity. [Footnote references omitted.]

112. Based on the concepts and definitions cited in paragraphs 109-111, the Board concluded that the key to applying the financial-components approach can be summarized as follows:

a. The economic benefits provided by a financial asset (generally, the right to future cash flows) are derived from the contractual provisions that underlie that asset, and the entity that controls those benefits should recognize them as its asset.
b. A financial asset should be considered sold and therefore should be derecognized if it is transferred and control is surrendered.
c. A transferred financial asset should be considered pledged as collateral to secure an obligation of the transferor (and therefore should not be derecognized) if the transferor has not surrendered control of the financial asset.
d. Each liability should be recognized by the entity that is primarily liable and, accordingly, an entity that guarantees another entity's obligation should recognize only its obligation to perform on the guarantee.
e. The recognition of financial assets and liabilities should not be affected by the sequence of transactions that led to their existence unless as a result of those transactions the transferor maintains effective control over a transferred asset.
f. Transferors and transferees should account symmetrically for transfers of financial assets.

113. Most respondents to the Exposure Draft generally supported the financial-components approach, especially as it applies to securitization transactions.

114. The concepts underlying the financial-components approach could be applied by analogy to accounting for transfers of nonfinancial assets and thus could result in accounting that differs significantly from that required by existing standards and practices. However, the Board believes that financial and nonfinancial assets have significantly different characteristics, and it is not clear to what extent the financial-components approach is applicable to nonfinancial assets. Nonfinancial assets have a variety of operational uses, and management skill plays a considerable role in obtaining the greatest value from those assets. In contrast, financial assets

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have no operational use. They may facilitate operations, and financial assets may be the principal "product" offered by some entities. However, the promise embodied in a financial asset is governed by contract. Once the contract is established, management skill plays a limited role in the entity's ability to realize the value of the instrument. Furthermore, the Board believes that attempting to extend this Statement to transfers of nonfinancial assets would unduly delay resolving the issues for transfers of financial assets, because of the significant differences between financial assets and nonfinancial assets and because of the significant unresolved recognition and measurement issues posed by those differences. For those reasons, the Board concluded that existing accounting practices for transfers of nonfinancial assets should not be changed at this time. The Board further concluded that transfers of servicing assets and transfers of property subject to operating leases are not within the scope of this Statement because they are nonfinancial assets.

115. The following paragraphs discuss the application of the concepts and principles described in paragraphs 109-114. First, circumstances that require derecognition of transferred assets and recognition of assets and liabilities received in exchange are discussed in the paragraphs about sales of financial assets, transfers to special-purpose entities, and other transfers (paragraphs 116-175). Then, the measurement of assets controlled and liabilities incurred (paragraphs 176-214) and subsequent measurement (paragraphs 215-217) are discussed. Finally, extinguishments of liabilities are discussed (paragraphs 218-224).

Sales of Financial Assets

116. If an entity transfers financial assets, surrenders control of those assets to a successor entity, and has no continuing involvement with those assets, accounting for the transaction as a sale and derecognizing the assets and recognizing the related gain or loss is not controversial. However, accounting for transfers of financial assets has been controversial and inconsistent in circumstances in which an entity transfers only a partial interest in a financial asset or has some other continuing involvement with the transferred asset or the transferee.

117. Under the financial-components approach, the accounting for a transfer is based on whether a transferor surrenders control of financial assets. Paragraph 3 of Statement 77 states, "This Statement establishes standards of financial accounting and reporting by transferors for transfers of receivables with recourse that *purport to be sales* of receivables" (emphasis added). The Board believes that, while it may have some significance at law, a more exacting test than whether a transaction purports to be a sale is needed to conclude that control has been surrendered in a manner that is consistent with the definitions in Concepts Statement 6. The Board concluded that a sale occurs only if control has been surrendered to another entity or group of entities and that surrender of control depends on whether (a) transferred assets have been isolated from the transferor, (b) transferees have obtained the right to pledge or exchange either the transferred assets or beneficial interests in the transferred assets, and (c) the transferor does not maintain effective control over the transferred assets through an agreement to repurchase or redeem them before their maturity.

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118. The Board developed its criterion that transferred assets must be isolated—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraph 9(a))—in large part with reference to securitization practices. Credit rating agencies and investors in securitized assets pay close attention to (a) the possibility of bankruptcy or other receivership of the transferor, its affiliates, or the special-purpose entity, even though that possibility may seem unlikely given the present credit standing of the transferor, and (b) what might happen in such a receivership, because those are major areas of risk for them. If certain receivers can reclaim securitized assets, investors will suffer a delay in payments due them and may be forced to accept a pro rata settlement. Credit rating agencies and investors commonly demand transaction structures that minimize those possibilities and sometimes seek assurances from attorneys about whether entities can be forced into receivership, what the powers of a receiver might be, and whether the transaction structure would withstand receivers' attempts to reach the securitized assets in ways that would harm investors. Unsatisfactory structures or assurances commonly result in credit ratings that are no higher than those for the transferor's liabilities and in lower prices for transferred assets.

119. Because legal isolation of transferred assets has substance, the Board decided that it could and should serve as an important part of the basis for determining whether a sale should be recognized. Some constituents expressed concern about the feasibility of an accounting standard based on those legal considerations, but the Board concluded that having to consider only the evidence available should make that requirement workable.

120. Respondents to the Exposure Draft raised several questions about the application of the isolation criterion in paragraph 9(a) to existing securitization structures. The questions included whether it was necessary to consider separately the accounting by the first-tier special-purpose entity, whose transfer to the second-tier trust taken by itself might not satisfy the isolation test. After considering those comments and consulting with respondents who specialize in the structure of securitization transactions, the Board concluded that related language in Appendix A should be revised to explain that that criterion can be satisfied either by a single transaction or by a series of transactions considered as a whole. As discussed in paragraphs 54-58, the Board understands that the series of transactions in a typical two-tier structure taken as a whole may satisfy the isolation test because the design of the structure achieves isolation.

121. The Board understands that a one-tier structure with significant continuing involvement by a transferor subject to the U.S. Bankruptcy Code might not satisfy the isolation test, because a trustee in bankruptcy has substantial powers that could alter amounts that investors might receive and thus it may be difficult to conclude that control has been relinquished. Some respondents argued that a one-tier structure with continuing involvement generally should be adequate if the transferor's credit rating is sufficiently high that the chance of sudden bankruptcy is remote. The Board did not accept that view because isolation should not depend on the credit standing of the transferor. The Board believes that a one-tier structure may satisfy the isolation test despite continuing involvement if the transferor is subject to receivership by receivers with more limited powers over transferred assets, for example, the FDIC. The Board understands that the FDIC,

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unlike a receiver in bankruptcy, cannot impose an automatic stay. However, it can terminate the transaction by paying investors compensation equivalent to all principal and interest earned to date, in effect making the investors whole.

122. The second criterion (paragraph 9(b)) for a transfer to be a sale focuses on whether the transferee has the right—free of conditions that constrain it from taking advantage of that right—to pledge or exchange the transferred assets. That criterion is consistent with the idea that the entity that has an asset is the one that can use it in the various ways set forth in Concepts Statement 6, paragraph 184 (quoted in paragraph 109 of this Statement). A transferee may be able to use a transferred asset in some of those ways but not in others. Therefore, establishing criteria for determining whether control has been relinquished to a transferee necessarily depends in part on identifying which ways of using the kind of asset transferred are the decisive ones. In the case of transfers of financial assets, the transferee holds the assets, but that is not necessarily decisive because the economic benefits of financial assets consist primarily of future cash inflows. The Board concluded that the ways of using assets that are important in determining whether a transferee holding a financial asset controls it are the ability to exchange it or pledge it as collateral and thus obtain all or most of the cash inflows that are the primary economic benefits of financial assets. As discussed in paragraph 127, if the transferee is a special-purpose entity, the ultimate holders of the assets are the beneficial interest holders, and the important rights concern their ability to exchange or pledge their interests.

123. The Exposure Draft proposed that a transferee be required to have the right—free of transferor-imposed conditions—to pledge or exchange the transferred assets for a transfer to qualify as a sale. Respondents to the Exposure Draft observed that some transferor-imposed conditions may not indicate that the transferor retains control over the assets transferred. The respondents suggested that some conditions are imposed for business or competitiveness purposes, not to keep control over future economic benefits of the transferred assets, and that those conditions should not preclude a transfer from being accounted for as a sale. Other respondents noted that not all conditions that might limit a transferee's ability to take advantage of a right to pledge or exchange transferred assets were necessarily imposed by the transferor. The Board decided that the criterion should not be restricted to being transferor imposed and that some conditions, described in paragraph 25, should not disqualify a transaction, so long as those conditions do not constrain the transferee from taking advantage of its right to pledge or exchange the transferred assets.

Settlement Date and Trade Date Accounting

124. Many transfers of financial assets have been and, under this Statement, will be recognized at the settlement date. During its redeliberations, the Board discussed the implications of this Statement on trade date accounting for certain securities transactions, and concluded that this project did not set out to address that issue. Therefore, the Board decided that this Statement should not modify generally accepted accounting principles, including FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* and AICPA Statements of Position

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and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities. The Board observes that the AICPA's Securities Contracts Task Force is currently developing a proposed Statement of Position that would clarify for all entities the date at which to recognize (or derecognize) contracts to purchase or sell securities in (or from) the statement of financial position.

Transfers to Qualifying Special-Purpose Entities, Including Securitizations

125. Many transfers of financial assets are to qualifying special-purpose entities of the type described in paragraph 26. After those transfers, the qualifying special-purpose entity holds legal title to the transferred assets but does not have the right to pledge or exchange the transferred assets. Rather, the activities of the qualifying special-purpose entity are limited to carrying out the provisions of the legal documents that established it. One significant purpose of those limitations on activities often is to make remote the possibility that a qualifying special-purpose entity could enter bankruptcy or other receivership, even if the transferor were to enter receivership.

126. Some respondents asked whether the special-purpose entity criteria apply to entities formed for purposes other than transfers of financial assets. The Board decided that the description of a special-purpose entity in paragraph 26 is restrictive. Transfers to entities that meet all of the conditions in paragraph 26 qualify for sale accounting under paragraph 9 of this Statement. Other entities with some similar characteristics also might be broadly described as "special-purpose." For example, an entity might be formed for the purpose of holding specific nonfinancial assets and liabilities or carrying on particular commercial activities. The Board decided that those entities are not qualifying special-purpose entities as the term is used in this Statement, and the accounting for transfers of financial assets to special-purpose entities should not be extended to transfers to any entity that does not satisfy all of the conditions in paragraph 26.

127. Qualifying special-purpose entities issue beneficial interests of various kinds—variously characterized as debt, participations, residual interests, and otherwise—as required by the provisions of those agreements. Holders of beneficial interests in the qualifying special-purpose entity have the right to pledge or exchange those interests but do not control the individual assets held by the qualifying special-purpose entity. The effect of establishing the qualifying special-purpose entity is to merge the contractual rights in the transferred assets and to allocate undivided interests in them—the beneficial interests. Therefore, the right of holders to pledge or exchange those beneficial interests is the counterpart of the right of a transferee to pledge or exchange the transferred assets themselves.

128. Sometimes financial assets, especially mortgage loans, are securitized and the transferor retains all of the beneficial interests in the qualifying special-purpose entity as securities. The objective is to increase financial flexibility because securities are more liquid and can more readily be sold or pledged as collateral to secure borrowings. In some cases, securitization may

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reduce regulatory capital requirements. The Board concluded that transfers of financial assets to a qualifying special-purpose entity, including securitizations, should qualify as sales only to the extent that consideration other than beneficial interests in the transferred assets is received.

129. The Board observes that a special-purpose entity that has distinct standing at law may still be an affiliate of the transferor, and therefore its assets and liabilities may be required to be included with those of the transferor in consolidated financial statements. That issue is dealt with in generally accepted accounting principles for consolidated financial statements. Many respondents maintained that existing principles are not clear and asked the Board to develop within this Statement additional consolidation guidance for special-purpose entities. The Board concluded that this Statement is not intended to change existing generally accepted accounting principles for consolidation issues. However, the Board acknowledges that consolidation of special-purpose entities is an issue that merits further consideration and is committed to deliberating that issue in its current project on consolidated financial statements.

Securitizations with Revolving-Period Features

130. As noted in paragraph 48, in some securitizations, short-term receivables are transferred to a special-purpose entity, and the special-purpose entity then issues long-term beneficial interests. Collections from transferred receivables are used to purchase additional receivables during a defined period called the revolving period. Thereafter, the collections are used to redeem beneficial interests in due course. Some have questioned the propriety of sales treatment in those securitizations because much of the cash collected during the revolving period is returned to the transferor. The Board decided that sales treatment was appropriate for transfers with revolving-period features because the transferor surrenders control of the assets transferred. While the revolving-period agreement requires that the transferor sell receivables to the trust in exchange for cash on prearranged terms, sales of additional receivables during the revolving period are separate transactions from the original sale.

131. The transferor in a transfer with a revolving-period agreement, such as a credit card securitization, must sell receivables to the securitization trust on prearranged terms. The transferor can perhaps predict the timing of transfers, but the actual timing depends primarily on borrower behavior. If not bound by that contract, the transferor could sell its new receivables elsewhere, possibly on better terms. The transferor obtains the cash as proceeds in exchange for new receivables transferred under the revolving-period agreement, not as benefits from its previous ownership of the receivables or its residual interest in the securitization trust.

132. The revolving-period agreement is an implicit forward contract, with rights and obligations on both sides. The transferor has little or no discretion to avoid its obligations under the revolving-period agreement and would suffer adverse consequences for failure to deliver receivables to the trust during the revolving period. For example, if the transferor were to take deliberate actions to avoid its obligations to sell receivables by triggering the agreement's "early amortization" provisions, the transferor would be exposed to litigation for not honoring its

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commitment. The transferor also could suffer if it later tried to sell its receivables in the securitization market: the transferor would probably have to offer wary investors a higher return. Deliberate early termination by the transferor is rare in practice because of those adverse consequences. Similarly, the securitization trust and investors cannot avoid the obligation to purchase additional receivables. For those reasons, the revolving-period agreement does not provide control over receivables previously sold but rather is an implicit forward contract for future sales of receivables.

133. Some respondents to the Exposure Draft proposed that existing revolving-period securitizations should continue to apply previous accounting standards for all transfers into an existing trust after the effective date of this Statement. Several respondents asked about the effect of the provisions of this Statement on transfers into a master trust that is used for a series of securitizations. They pointed out that it would be difficult to change the present structure of those trusts in response to new accounting standards. Others observed that because master trusts have very long or indefinite lives, "grandfathering" transfers to existing trusts would result in noncomparable financial statements for a long time to come. After considering those arguments, the Board decided to retain the proposed requirement that this Statement apply to all transfers of assets after its effective date, in order to minimize the noncomparability caused by the transition. However, the Board also responded to respondents' questions about accounting for master trusts by clarifying in paragraph 53 that a transfer into a master trust in exchange for beneficial interests is neither a sale nor a secured borrowing under the provisions of paragraph 9.

Other Transfers of Financial Assets

Repurchase Agreements and Securities Lending Transactions

134. The Exposure Draft proposed that transfers of financial assets with repurchase commitments, such as repurchase agreements and securities lending transactions, should qualify as secured borrowings only if the transfer was *assuredly temporary*—the period until repurchase is less than three months or the period is indefinite but the contracts are repriced daily at overnight market rates and can be terminated by either party on short notice. It also proposed that the assets to be repurchased had to be the same (for example, U.S. securities having the same CUSIP number) as those transferred. Respondents generally disagreed with those provisions of the Exposure Draft about these ambiguous transactions, and the Board changed those provisions in its redeliberations.

Legal and Economic Ambiguity of These Transactions

135. Repurchase agreements and securities lending transactions are difficult to characterize because those transactions are ambiguous: they have attributes of both sales and secured borrowings. Repurchase agreements typically are documented as sales with forward purchase contracts and generally are treated as sales in bankruptcy law and receivers' procedures, but as borrowings in tax law, under court decisions that cite numerous economic and other factors.

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Repurchase agreements are commonly characterized by market participants as secured borrowings, even though one reason that repurchase agreements arose is that selling and then buying back securities, rather than borrowing with those securities as collateral, allows many government agencies, banks, and other active participants in the repurchase agreement market to stay "within investment and borrowing parameters that delineate what they may or may not do." [14] Securities loans are commonly documented as loans of securities collateralized by cash or by other securities or by letters of credit, but the "borrowed" securities are invariably sold, free of any conditions, by the "borrowers," to fulfill obligations under short sales or customers' failure to deliver securities they have sold; securities loans are generally treated as sales under U.S. bankruptcy and tax laws (but only as they relate to income distributions).

136. Previous accounting practice generally has treated repurchase agreements as secured borrowings, although "repos-to-maturity" and certain other longer term repurchase agreements have been treated as sales. Previous accounting practice has not recognized some securities lending transactions, because the transactions were executed by an entity's custodian or other agent, and has treated others as secured borrowings. Supporting arguments exist for accounting for both kinds of transactions as borrowings, both kinds as sales, or some as borrowings and others as sales.

137. The American Law Institute [15] describes the legal status of a securities lending transaction as follows:

> The securities lender does not retain any property interest in the securities that are delivered to the borrower. The transaction is an outright transfer in which the borrower obtains full title . . . the borrower needs the securities to transfer them to someone else . . . if the securities borrower defaults on its redelivery obligation, the securities lender has no property interest in the original securities that could be asserted against any person to whom the securities borrower may have transferred them. . . . The securities lender's protection is its right to foreclose on the collateral given to secure the borrower's redelivery obligation. Perhaps the best way to understand securities lending is to note that the word "loan" in securities lending transactions is used in the sense it carries in loans of money, as distinguished from loans of specific identifiable chattels. Someone who lends money does not retain any property interest in the money that is handed over to the borrower.

138. While that description focuses on securities lending, much of it appears applicable to repurchase agreements as well. If judged by the criteria in paragraphs 9(a) and 9(b) and the legal reasoning in paragraph 137, financial assets transferred under typical repurchase or securities lending agreements would qualify for derecognition as having been sold for proceeds consisting of cash and a forward purchase contract. During the term of the agreement, the transferred assets are isolated from the transferor, are placed in the hands of a transferee that can—and typically does—obtain their benefits by selling or pledging them, and are readily obtainable in the market.

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139. The Board considered requiring sales treatment for all of those transactions. The Board also considered an approach that would have recognized the effects of the transaction in the statement of financial position (recognizing the proceeds received as cash or securities and a forward purchase contract) without characterizing the transaction as a sale. The Board ultimately decided, for both conceptual and practical reasons, that secured borrowing treatment should be retained for most of those transactions.

140. In concept, having a forward purchase contract—a right and obligation to buy an asset—is not the same as owning that asset. Dividends or interest on securities are paid by the issuer to the current security holder, that is, to whoever may now hold the securities transferred in the repurchase agreement or loan, while the transferor has at most only the contractual right to receive—from the transferee—payments in lieu of dividends or interest. In addition, the voting rights reside not with the transferor but with the current security holder, because those rights generally cannot be contractually released.

141. However, the commitments entered into in a repurchase or securities lending agreement are more extensive than a common forward purchase contract. The transferor has agreed to repurchase the security, often in as little as a day, at a fixed price that differs from the sale price by an amount that is essentially interest on the cash transferred. The transferor also commonly receives payments in lieu of interest or dividends and has protection of collateral that is valued daily and adjusted frequently for changes in the market value of the transferred asset—collateral that the transferor is entitled to use to purchase replacement securities should the transferee default, even in the event of bankruptcy or other receivership. Those arrangements are not typical of forward purchase contracts and suggest that having a repurchase agreement or securities lending contract to repurchase a transferred asset before its maturity is much like still owning that asset.

142. Practically, participants in the very large markets for repurchase agreements and securities lending transactions are, for the most part, unaccustomed to treating those transactions as sales, and a change to sale treatment would have a substantial impact on their reported financial position. Given the difficulty in characterizing those ambiguous transactions, the decision to treat all of those transactions as sales would be a close call, and the Board was not convinced that the benefits of a change based on that close call would justify the costs.

143. The Exposure Draft proposed that transfers of financial assets with repurchase commitments, such as repurchase agreements and securities lending transactions, should be accounted for as secured borrowings if the transfers were assuredly temporary, and as sales if the transfers were not assuredly temporary. As proposed, to be assuredly temporary, the period until repurchase would have had to be short enough not to diminish assurance that the contract and arrangements backing it up would prove effective, that is, with maturities either under three months or indefinite and terminable by either party on short notice. Also, to be assuredly temporary, the entity would have had to be entitled and obligated to repurchase the same assets.

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After considering comment letters and testimony at the public hearing, the Board decided to change both of those proposed requirements.

The Period until Repurchase

144. The Exposure Draft proposed that transfers of financial assets should qualify as borrowings if the period until repurchase is less than three months or the period is indefinite but the contracts are repriced daily at overnight market rates and can be terminated by either party on short notice. A three-month limit was arbitrary, but based on its initial inquiries, the Board tentatively concluded that three months would be a clear and workable time limit that should not present difficulty, because it understood that most repurchase agreements and securities loans are for periods much shorter than three months or are indefinite, and almost all of the others are for periods much longer than three months.

145. Respondents generally disagreed with that provision of the Exposure Draft. They argued that the arbitrary three-month limit would not be effective and that entities could alter the accounting for a transfer by adding or subtracting one or two days to or from the term of the agreement. While some offered other arbitrary time limits, many respondents argued that all transfers accompanied by a forward contract to repurchase the transferred assets before maturity should be accounted for as secured borrowings. In their view, most repurchase agreements represent a temporary transfer of only some elements of control over the transferred assets.

146. After considering those comments, the Board decided to remove the proposed requirement that the period until repurchase be less than three months. Board members concluded that any distinction based on the specified time until repurchase would not be workable. As outlined in paragraph 141, the elements of control by the transferee over assets obtained in a typical securities lending or repurchase agreement are both temporary and limited. The Board concluded that the contractual obligation and right to repurchase an asset before its maturity effectively bind the asset transferred back to the transferor.

147. Some respondents suggested a distinction based on a different time period, or on the proportion of the life of the asset transferred, but the Board rejected those possibilities. Any other time period would have the same faults as the three-month limit proposed in the Exposure Draft: it would be arbitrary, with no meaningful distinction between transactions just on one side of the limit and those just on the other side. Similarly, the Board concluded that the only meaningful distinction based on required repurchase at some proportion of the life of the assets transferred is between a "repo-to-maturity," in which the typical settlement is a net cash payment, and a repurchase before maturity, in which the portion of the asset that remains outstanding is indeed reacquired in an exchange.

Substantially the Same Assets

148. The Exposure Draft proposed that a repurchase agreement would have to require return of the same asset (for example, U.S. securities having the same CUSIP number) for the transfer to

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be treated as a borrowing. In the Exposure Draft, the Board reasoned that agreements to acquire securities that—while perhaps similar—are not the same as those transferred do not maintain any kind of control over the transferred securities. Most repurchase agreements require return of the same asset. Some are less rigid. For example, some mortgage-backed instruments are transferred in a class of repurchase agreements known as *dollar rolls.* There are several procedural differences between dollar-roll transactions and ordinary repurchase agreements. However, the most significant difference is the agreement that assets returned need not be the same as those transferred. Instead, the transferor agrees to accept back assets with characteristics that are substantially the same within limits established by the market.

149. While a few respondents supported the Exposure Draft's reasoning, most did not. Respondents argued that the economic differences between the assets initially transferred and assets to be reacquired under a dollar-roll transaction that meets the existing accounting criteria for being substantially the same are, as the term implies, not substantial and should not result in an accounting difference. They argued that existing accounting guidance found in AICPA Statement of Position No. 90-3, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position,* has proven adequate to constrain the characteristics of assets that are to be reacquired. After redeliberation, the Board accepted those arguments and decided that if the assets to be repurchased are the same or substantially the same as those concurrently transferred, the transaction should be accounted for as a secured borrowing. The Board also decided to incorporate the definition in SOP 90-3 in this Statement. The Board noted that not all contracts in the dollar-roll market require that the securities involved have all of the characteristics of "substantially the same." If the contract does not require that, the transferor does not maintain effective control.

The Importance of the Right* and *Obligation to Repurchase, Collateral, and Symmetry

150. The Board based its decisions about agreements that maintain effective control over transferred assets in part on observation of contracts and practices that prevail in the repurchase agreement and securities lending markets. Concerns of market participants about risk of default by the parties to the contract, rights at law in the event of default, and credit risk of transferred assets, among other factors, have led to several contractual features intended to assure that the transferors indeed maintain effective control.

151. The Board decided that to maintain effective control the transferor must have *both* the contractual right *and* the contractual obligation to reacquire securities that are identical to or substantially the same as those concurrently transferred. Transfers that include only the right to reacquire, at the option of the transferor or upon certain conditions, or only the obligation to reacquire, at the option of the transferee or upon certain conditions, generally do not maintain the transferor's control, because the option might not be exercised or the conditions might not occur. Similarly, expectations of reacquiring the same securities without any contractual commitments, as in "wash sales," provide no control over the transferred securities.

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152. The Board also decided that the transferor's right to repurchase is not assured unless it is protected by obtaining collateral sufficient to fund substantially all of the cost of purchasing identical replacement securities during the term of the contract so that it has received the means to replace the assets even if the transferee defaults. Judgment is needed to interpret the term *substantially all* and other aspects of the criterion that the terms of a repurchase agreement do not maintain effective control over the transferred asset. However, arrangements to repurchase or lend readily obtainable securities, typically with as much as 98 percent collateralization (for entities agreeing to repurchase) or as little as 102 percent overcollateralization (for securities lenders), valued daily and adjusted up or down frequently for changes in the market price of the security transferred and with clear powers to use that collateral quickly in event of default, typically fall clearly within that guideline. The Board believes that other collateral arrangements typically fall well outside that guideline.

153. Some respondents argued for a continuation of previous asymmetrical practices in accounting for dollar rolls. In previous practice, transferors have accounted for dollar-roll agreements as borrowing transactions, while dealers who receive the transferred assets have accounted for them as purchases. The Board observed that the same transaction cannot in concept or simple logic be a borrowing-lending arrangement to the transferor and a purchase-sale transaction to the transferee. The Exposure Draft would have resolved that asymmetry by requiring that transferors account for the transactions as sales. In response to respondents' concerns about transferors' accounting, this Statement instead calls for transferors to account for qualifying dollar-roll transactions as secured borrowings and requires that dealers account for the same transactions as secured loans.

Agreements Entitling the Transferor to Repurchase or Redeem Assets That Are Not Readily Obtainable

154. The Board considered whether to allow sale treatment if a transferor of financial assets concurrently acquires from the transferee a call option on the assets sold. Some questioned whether the transferor that holds a call option has surrendered control of the assets to the transferee. Some believe that an entity that holds an option to acquire a financial asset controls that asset. However, the holder of a call option does not receive interest or dividends generated by the asset, cannot exercise any voting rights inherent in the asset, may not be aware of the location or present custody of the asset, and is not able to sell the asset and deliver it without first exercising the call. And it may never exercise the call. If an entity that holds a call option on an asset controls that asset, then it follows that the entity should recognize the asset under the call option at the time the call option is acquired. However, two parties would then recognize the same asset—the entity that holds the call option and either the writer of the call option or the party from whom the writer plans to acquire the asset if the call is exercised.

155. The Board concluded that sale treatment should not be precluded in instances in which the transferor simultaneously obtains a call option on the asset sold, provided that the asset is readily obtainable. The writer of a call option on a financial asset may choose not to own the asset under the call option if it is readily obtainable; it may instead plan to acquire that asset if the call

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is exercised and delivery is demanded. In those circumstances, it is realistic to assume that the transferee can sell or repledge the asset to a third party and, at the same time, in good faith write a call option on that asset.

156. The Board concluded that a sale should not be recognized in instances in which the transferor simultaneously obtains a call on a transferred asset that is not readily obtainable. The resulting accounting treatment of an option on a not-readily-obtainable asset that is obtained as part of a transfer of financial assets is different from the accounting treatment generally accorded to the same option that is purchased for cash. From the transferor's viewpoint, that difference in accounting treatment between an option purchased and an option obtained as part of a transfer of assets conflicts with the principle that the recognition of financial assets and liabilities should not be affected by the sequence of transactions that led to their existence. However, as noted in paragraph 25, if the option is a component of a transfer of financial assets, and it does not constrain the transferee from selling or repledging the asset, that should not preclude the transfer from being accounted for as a sale. If the existence of an option constrains the transferee from selling or repledging the transferred asset (because the asset is not readily obtainable to satisfy the option if exercised), then the transferor has not relinquished effective control over the asset and thus should not derecognize it.

Assets Obtained as Collateral That Can Be Sold or Repledged

157. The Exposure Draft proposed that for transactions involving collateral, including securities lending transactions and repurchase agreements, secured parties should recognize all cash collateral received as well as all other financial instruments received as collateral that they have the ability by contract or custom to sell or repledge prior to the debtor’s default, because they have important rights over that collateral. Secured parties in those positions are entitled and able to use the cash received as collateral, or the cash they can obtain by selling or repledging other collateral, for their own purposes. Therefore, in the Exposure Draft, the Board concluded that that collateral is the secured party’s asset, along with an obligation to return the collateral that is the secured party’s liability. In the Exposure Draft, the Board reasoned that if that collateral was permitted to be excluded from the statement of financial position, assets that secured parties can use to generate income would not be recognized. Reporting income but not the assets that generate it could understate a secured party's assets (and liabilities) as well as overstate its return on assets. In contrast, noncash collateral that secured parties are not able to sell or repledge cannot be used to generate cash or otherwise benefit the secured party (other than by reducing the credit risk on the financial asset it secures, an effect already recognized in measuring that financial asset) and is not the secured party’s asset.

158. The Board noted that the accounting proposed was consistent with Governmental Accounting Standards Board (GASB) Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions,* that was issued in May 1995. GASB Statement 28 also required, for reasons similar to those noted in this Statement, that securities lenders record noncash collateral if the contract specifically allows the governmental entity to pledge or sell the

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collateral before a debtor defaults.

159. Many respondents objected to recognition of collateral because they contended that the proposed accounting would result in the same asset being recognized by two entities. As discussed in paragraph 172 and in the Exposure Draft, while the secured party reports the security as its asset, the transferor reports a different asset, a receivable for the return of the collateral from the secured party. Respondents also argued that recognizing the collateral implies that the secured party expects all the benefits of that asset, whereas it typically is not entitled to retain dividends, interest, or benefits from appreciation. Respondents who objected to recognizing collateral generally preferred that secured parties disclose collateral received. Other respondents suggested that it was not clear that the collateral provisions applied not only to a secured borrowing but also to collateral pledged in all other kinds of transactions.

160. The Board reconsidered the provisions of the Exposure Draft in light of those comments. To improve clarity and refine its conclusions, the Board focused on four circumstances in which a secured party arguably should recognize collateral it has received: (a) cash collateral, (b) collateral securing obligations in default, (c) other collateral that the secured party has sold or repledged, and (d) other collateral that the secured party can sell or repledge.

Cash Collateral

161. Some respondents objected to recording any asset received as collateral, even cash, on the grounds that it remains the asset of the party posting it as collateral and is therefore not the secured party's asset. Other respondents agreed that cash collateral should be recognized because transfers of financial assets in exchange for cash collateral cannot be distinguished from borrowing cash and because cash is fungible. It is therefore impossible to determine whether it has been used by the secured party. The Board concluded for the latter reason that all cash collateral should be recorded as an asset by the secured party, together with a liability for the obligation to return it to the transferor, whose asset is a receivable.

Collateral Securing Obligations in Default

162. Many respondents pointed out that collateral securing an obligation becomes the property of the secured party upon default on the secured obligation. A respondent argued differently, maintaining that a defaulting debtor does not relinquish control over the collateral until it no longer has an opportunity to redeem the collateral by curing the default. The Board agreed that the secured party should recognize collateral to the extent it has not already recognized the collateral if the debtor defaults and is no longer entitled to redeem it.

Other Collateral That the Secured Party Has Sold or Repledged

163. Some respondents who agreed that cash collateral should be recognized argued that the secured party should not recognize other collateral unless the debtor had defaulted, no matter what powers it has over that collateral, again because in their view the transferred assets remain

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the assets of the transferor. Others argued that while it may make sense for the secured party to recognize an obligation if collateral is sold, as is common practice in some industries, it is not common practice for broker-dealers and others to recognize an asset and a liability when they repledge collateral. Respondents from the broker-dealer community noted that they regularly repledge substantial amounts of collateral in conjunction with loans secured by customer margin balances and "borrow versus pledge" matched securities transactions and that that collateral activity has not been recognized under previous practice, although it has been disclosed. After considering those arguments, the Board concluded that collateral should be considered for recognition when it is sold or repledged, because the ability to pledge or exchange an asset is the benefit that the Board determined constitutes control over a financial asset, as set forth in paragraph 9(b) and discussed in paragraphs 122 and 123.

164. One respondent observed that the documentation supporting some transactions preserves the transferor's legal right to redeem its collateral, even though the transferee has repledged the assets to a third entity. In those instances, should the transferee default, the transferor has rights to redeem its collateral directly from the third entity to which the initial transferee repledged it. The respondent argued that a transferee with that right has not surrendered control over the assets. The Board agreed with that reasoning and adopted it. Because the status of the right to redeem may not always be clear, the Board chose to implement it by requiring recognition of collateral by the secured party if it sells or repledges collateral on terms that do not enable it to repurchase or redeem the collateral from the transferor on short notice. One result is that broker-dealers and others who obtain financial assets in reverse repurchase agreements, securities loans, or as collateral for loans and then sell or repledge those assets will in some cases recognize under this Statement assets and liabilities that previously went unrecognized. The Board noted that obligations to return to the transferor assets borrowed and then sold have sometimes been effectively recognized as part of a liability for securities sold but not yet purchased, and did not require change in that practice.

Other Collateral That the Secured Party Can Sell or Repledge

165. The Exposure Draft called for recognition of collateral that the secured party can repledge or exchange but has not yet used. Some argued that secured parties should not be required to recognize any unused collateral, reasoning that the collateral and related obligation did not meet the definition of an asset or a liability of the secured party. They contended that to be considered an asset of the secured party the collateral must embody a probable future economic benefit that contributes directly or indirectly to future net cash inflows and that in the case of many kinds of collateral, there is only a possible benefit that has not been realized until that collateral is sold or repledged. The Board disagreed, noting that collateral that can be sold or repledged has a capacity to contribute directly to future cash inflows—from a sale or secured borrowing—and that the obligation to return the collateral when reclaimed will require a future economic sacrifice—the relinquishing of control. The Board also observed that broker-dealers and others are able to benefit from collateral in various ways and that the right to benefit from the use of a financial asset is, in itself, an asset.

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166. A respondent pointed out that the right to repledge or exchange is significantly constrained if the transferor has the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract on short notice, and thereby demand the return of the particular security pledged as collateral. The Board agreed, reasoning that a transferor that can redeem its pledged collateral on short notice has not surrendered control of the transferred assets. The transferee will be able to use the transferred assets in certain ways to earn a return during the period of the agreement, but the value of its asset may be very limited because of the transferor's rights to substitute or cancel.

167. The Board considered an approach that would have recorded only the net value of the specific rights that the secured party has over the collateral. That approach might have been consistent with the financial-components approach, and several respondents asked the Board to consider it. However, no one, including the Board, was able to identify a method that the Board judged to be sound for separating the collateral into components.

168. Another possibility considered would have been to recognize the transfer of control over the collateral and for the two parties each to report their mutual rights and obligations under the contract net, that is, for the debtor to net its receivable for the transferred security against its obligation under the secured borrowing and for the secured creditor to net its obligation to return the security against its secured loan receivable. The only change to the statement of financial position would have been the difference in carrying amounts, if any, with a note disclosing the details. That approach is different from present practice in its details but would have produced similar total assets and liabilities. It arguably would have been more consistent with the financial-components approach that focuses on control and would have simplified the accounting. While this approach appealed to some Board members, the Board ultimately rejected it. The approach would have been inconsistent with other pronouncements that govern offsetting, because in this case there is no intent to settle net.

169. After considering comments and testimony on those matters, the Board decided that financial assets transferred as collateral in a secured borrowing should be recognized by the secured party as an asset with a corresponding liability for the obligation to return the collateral if the secured party is permitted by contract or custom to sell or repledge the collateral and the transferor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract.

170. In addition, because there appears to be significant variation in practice, the Board decided to require entities to disclose their policies for requiring collateral or other security for securities lending transactions and repurchase agreements to inform users about the credit risk that entities assume in those transactions. Respondents did not object to that proposed disclosure.

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Security Interests, Custodial Arrangements, Contributions, and Other Transfers That Do Not Qualify as Sales

171. The Board concluded that a borrower that grants a security interest in financial assets should not derecognize the financial assets during the term of the secured obligation. Although the borrower's rights to those assets are restricted because it cannot sell them until the borrowing is repaid, it has not surrendered control if the lender cannot sell or repledge the assets unless the borrower defaults. That assets subject to a security interest have been pledged, and are therefore collateral in the possession of the lender or the lender's agent, does not affect recognition by the debtor because effective control over those assets remains with the debtor in the absence of default under the terms of the borrowing.

172. To maintain symmetry in the accounting of secured parties and debtors (paragraphs 157-170), the Board decided that debtors should redesignate in their statements of financial position collateral that has been put into the hands of a secured party that is permitted by contract or custom to sell or repledge it and which they are not entitled and able to redeem on short notice, for example, by substituting other collateral or terminating the arrangement. That redesignation avoids a situation in which two or more entities report the same assets as if both held them (as could occur under previous accounting practices).

173. Under previous practice, financial assets transferred to another party for safekeeping or custody continue to be carried as assets by the transferor. The only consideration exchanged in those transfers is, perhaps, payment of a fee by the transferor to the custodian for the custodial services. The custodian does not control the assets but must follow the transferor's instructions. The Board concluded that existing practice should continue and that this Statement need not deal with transfers of custody for safekeeping.

174. Some transfers of financial assets are unconditional nonreciprocal transfers that are contributions. The Board did not address them in this Statement because accounting for contributions is addressed in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*.

175. Some transfers of financial assets will fail to meet the criteria specified in paragraph 9 to be accounted for as sales even though they might be structured as and purport to be sales. The Board concluded that those transfers should be accounted for as secured borrowings.

Measurement under the Financial-Components Approach

176. Following a transfer of financial assets that qualifies as a sale, assets retained or obtained and liabilities incurred by the transferor could at first be measured at either (a) fair value at the date of the transfer or (b) an allocated portion of the transferor's carrying amount for the assets transferred.

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177. The usual initial measure of assets and liabilities is the price in an exchange transaction or the equivalent fair value. Paragraph 88 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* states:

> Initial recognition of assets acquired and liabilities incurred generally involves measurement based on current exchange prices at the date of recognition. Once an asset or a liability is recognized, it continues to be measured at the amount initially recognized until an event that changes the asset or liability or its amount occurs and meets the recognition criteria.

178. In APB Opinion No. 29, *Accounting for Nonmonetary Transactions,* the Accounting Principles Board, in prescribing the basis for measurement of assets received in nonmonetary exchanges, states:

> . . . in general accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved which is the same basis as that used in monetary transactions. [Paragraph 18, footnote reference omitted.]

179. The Board believes that those concepts should be applied to new interests obtained or incurred in transfers of financial assets. At issue is whether the financial assets controlled and liabilities incurred in a transfer of financial assets that qualifies as a sale are new to the transferor and thus are part of the proceeds from the transfer, subject to initial measurement using the concepts summarized in paragraphs 177 and 178, or instead are retained beneficial interests over which the transferor has not surrendered control that need not be subject to new measurement under those concepts. The Board concluded that the answer depends on the type of financial instrument or other interest held or incurred.

180. The Board decided that a distinction can and should be made between new assets and liabilities that are part of the proceeds from the transfer and continuing interests in retained assets held in a new form. Cash received as proceeds for assets sold has no continuing connection with those assets and is clearly a new asset. Unrelated assets obtained also are clearly new assets, for example, a government bond received in exchange for transferred accounts receivable. Any asset received that is not an interest in the transferred asset is new to the transferor and thus is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is an obligation that is new to the transferor and thus a reduction of proceeds. Therefore, all of those new assets and liabilities should be initially measured at fair value. The issue becomes more challenging for assets controlled after a sale that are related to the assets sold.

Measuring Liabilities and Derivative Financial Instruments Related to Assets Sold at Fair Value

181. An entity that sells a financial asset may incur liabilities that are related to the assets sold. A common example of a liability incurred by the transferor is a recourse or guarantee obligation. Certain risks, such as recourse or guarantees, are inherent in the original financial asset before it

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is transferred, which might seem to support carrying over the prior carrying amount. However, before the transfer, the transferor has no obligation to another party; after the transfer, it does. The Board concluded that liabilities incurred in a transfer of financial assets are therefore new and should be initially measured at fair value.

182. An entity that sells a financial asset may enter into derivative financial instrument contracts that are related to the assets sold, for example, options, forwards, or swaps. One example of a related contract is an option that allows purchasers of receivables to put them back to the transferor, which is similar to a recourse obligation. Another example is a repurchase commitment held by the seller in a repurchase agreement that is accounted for as a sale, [16] which is a kind of forward contract. A third example is an agreement similar to an interest rate swap in which the transferor receives from a securitization trust the fixed interest amounts due on securitized receivables and pays the trust variable amounts based on a floating interest rate index. Under present practice, a party to an option or a forward purchase or sale commitment generally does not recognize the acquisition or disposition of the underlying assets until and unless delivery occurs. A party to a swap recognizes net amounts receivable or payable under the swap rather than the full notional amounts of the reference contracts. Options, forward commitments, swaps, and other derivative contracts are financial assets or liabilities separate and apart from the underlying asset. For that reason and because of the practical need to make a workable distinction, the Board concluded that derivative financial instruments entered into by a seller in an exchange for a financial asset are newly created in the transaction and should be considered part of the proceeds and initially measured at fair value at the date of exchange.

183. Respondents to the Exposure Draft asked the Board to provide more detailed guidance on how they should differentiate between an asset or liability that is part of the proceeds of a transfer and a retained interest in transferred assets. The Board acknowledges that, at the margin, it may be difficult to distinguish between a retained interest in the asset transferred and a newly created asset. The Board believes that it is impractical to provide detailed guidance that would cover all possibilities. A careful examination of cash flows, risks, and other provisions should provide a basis for resolving most questions. However, the Board agrees that it would be helpful to provide guidance if an entity cannot determine how to classify an instrument and decided that in that case the instrument should be considered to be a new asset and thus part of the proceeds of the sale initially measured at fair value.

Measuring Retained Interests in Assets Sold at Allocated Previous Carrying Amount

184. The Board decided that all other interests in the transferred financial assets held after a securitization or other transfer of financial assets should be measured at their previous carrying amount, allocated between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of the transfer. Retained interests in the transferred assets continue to be assets of the transferor, albeit assets of a different kind, because they never left the possession of the transferor and, thus, a surrender of control cannot have occurred. Therefore, the retained interests should continue to be carried at their allocated previous carrying amount,

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with no gain or loss recognized. Defining this category as the residual set of interests in transferred instruments held after the transfer (those interests that are neither derivatives nor liabilities of the transferor) establishes a clearer distinction between assets and liabilities that are part of the proceeds of the transfer and retained interests.

Other Alternatives Considered

185. In developing the Exposure Draft, the Board considered several alternative measurement approaches including (a) measuring all assets held after a securitization or sale of a partial undivided interest (either a pro rata interest or a nonproportional interest) initially at fair value, (b) measuring interests held after a securitization at fair value and measuring retained undivided interests at allocated previous carrying amounts, and (c) measuring all interests in transferred financial assets held after a transfer at their allocated previous carrying amounts. Some respondents to the Exposure Draft supported each of those approaches. However, most respondents agreed with the Board's reasoning that a retained interest in a transferred asset represents continuing control over a previous asset, albeit in different form, and thus should not be remeasured at fair value. Most respondents also accepted the approach proposed in the Exposure Draft as workable.

186. Another possibility that was rejected by the Board was to allocate the carrying amount between the portion of an asset sold and the portion of an asset retained based on relative fair values at the date the receivable was originated or acquired by the transferor, adjusted for payments and other activity from the date of acquisition to the date of transfer. The consensus reached in EITF Issue No. 88-11, "Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold," required use of that acquisition date method unless it is not practical, in which case the allocation should be based on relative fair values at the date of sale. In its deliberations on this Statement, the Board decided to require allocation based on fair values at the date of sale or securitization because it is more representative of the asset's value and the cost of re-creating the information from the date of acquisition would exceed the perceived benefits. The Board decided that the acquisition date method was not clearly superior in concept to an allocation based on fair values at the date of sale or securitization and, based in part on practices under that consensus, that that method was so often impractical because of recordkeeping difficulties that it was not useful as a general principle. No other possible methods of allocation appeared likely to produce results that were significantly more relevant.

Servicing Assets and Servicing Liabilities

187. Previously, net "mortgage servicing rights" were recognized as assets and those rights were accounted for in accordance with FASB Statements No. 65, *Accounting for Certain Mortgage Banking Activities,* and No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* and Statements 115 and 122. The amount recognized as net mortgage servicing rights was based on the fair value of certain expected cash inflows net of expected cash outflows. The expected cash inflows—future

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servicing revenues—included a normal servicing fee, [17] expected late charges, and other ancillary revenues. The expected cash outflows—future servicing costs—included various costs of performing the servicing. A separate "excess servicing fee receivable" was recognized if the servicer expected to receive cash flows in excess of a normal servicing fee, and a liability was recognized if the servicer expected to receive less than a normal servicing fee or if the entity's servicing costs were expected to exceed normal costs. The servicing rights asset was subsequently measured by amortization and assessment for impairment based on its fair value. That set of procedures has been called the mortgage servicing method.

188. Servicing assets and obligations for other assets sold or securitized were either accounted for like mortgage servicing or, more commonly, remained unrecognized until amounts were received and services were provided. Attempts have been made in practice to extend the mortgage servicing method to the servicing of other financial assets. However, identifying a normal servicing fee and other aspects of the mortgage servicing method have been difficult and disparate practices have resulted. The Board concluded it was necessary to address in this project accounting for servicing of all kinds of financial assets.

189. In October 1993, the Board decided to reconsider the accounting for mortgage servicing activities established in Statement 65. The primary thrust of that project was to resolve differences in the accounting for purchased versus originated mortgage servicing. Statement 122 was the result of that effort. In February 1995, the Board decided that accounting for excess mortgage servicing receivables and other servicing issues should be dealt with, to the extent necessary, not in that project but rather in this one, because those issues largely arise in transfers of financial assets and possible answers are necessarily interrelated. The Board considered alternative methods of accounting for servicing (the mortgage servicing method required by Statement 65, as amended by Statement 122, as well as a gross method and a right or obligation method) and chose a method that combines the best features of the mortgage servicing method and other possible methods.

Alternatives to the Mortgage Servicing Method

190. The mortgage servicing method described in paragraph 187 was required by Statement 65, as amended by Statement 122, for mortgage servicing rights. While that method was familiar to mortgage servicers and had certain advantages over other methods, the distinction between normal and excess servicing and other complexities of the method make it difficult to apply for some other kinds of servicing.

191. The Board considered a gross method that would have required that a servicer recognize both a servicing receivable asset consisting of expected future servicing revenues and a servicing obligation liability for the servicing work to be performed. The Board decided that it was questionable whether a receivable for servicing not yet rendered met the definition of an asset and that, given the conceptual questions, that method did not merit the large change in practice that it would have required.

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192. The Board also considered a right or obligation method that would have recognized a single item, commonly an asset but occasionally a liability, for each servicing contract. That asset or liability would have been the net of the gross asset and liability that would have been reported separately under the gross approach. The resulting asset would have been subsequently measured like an interest-only strip, that is, at fair value with unrealized gains and losses recognized in equity if available-for-sale. Some respondents suggested that servicing rights should be subsequently measured in that way, because reporting servicing rights at fair value would be more useful to investors and other financial statement users than the historical cost amortization and impairment methods of the mortgage servicing approach. Furthermore, under an approach like that in Statement 115, unrealized gains and losses would not have been recognized in earnings, but rather in a separate component of shareholders' equity.

193. The Board considered the right or obligation method well suited in several respects to the range of mortgage and other servicing contracts that now exist or might arise. However, the Board did not choose that method in part for the practical reason of avoiding an early change from the recently adopted provisions of Statement 122. Instead, the Board chose to combine the best features of that method—the simplicity of reporting only a single asset or liability for each servicing contract and not having to distinguish between normal and excess servicing—with the best features of the mortgage servicing method.

Recognition and Measurement of Servicing Assets and Servicing Liabilities

194. The method adopted in this Statement carries forward the amortization and impairment provisions that were required under the mortgage servicing method in Statements 65 and 122. The Board considers those subsequent measurement provisions workable. However, changes to the mortgage servicing method are necessary to adapt the accounting for mortgage servicing to all servicing assets and servicing liabilities, to reduce complexities for financial statement preparers and users, and to be compatible with the other recognition and initial measurement principles in this Statement.

195. One change is the elimination of the distinction between normal and excess servicing. The Board decided that that distinction has been too difficult to make except in markets as liquid as the market for residential mortgage servicing. The Board considered two ways in which normal and excess servicing might be retained in accounting for those liquid markets.

196. One way would have been to leave in place the accounting for servicing of mortgages as required in Statement 65, as amended by Statement 122, while using a different method that was not dependent on determining a normal servicing fee for all other servicing. However, the Board concluded that comparability of financial statements would have suffered if the accounting for essentially similar servicing activities differed depending on the type of asset serviced. Another way would have been to revise the definition of normal servicing fee rates so that servicers could determine a normal servicing fee rate in the absence of a developed secondary market for servicing. That change would have provided servicers of other types of loans or receivables

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(such as auto loans and credit card balances) with an opportunity to establish normal servicing rates and apply the mortgage servicing method to other servicing rights, rather than be subject to recognizing less gain or more loss on the sale of receivables because normal servicing was unknown. The Board considered that method but concluded that that alternative might result in continuing questions about what are normal servicing fees for different types of servicing.

197. The Board also noted that the distinction between normal and excess servicing, even in liquid markets, is no longer relevant for financial reporting because under current market practices, excess and normal servicing assets, which arise from a single contract, generally cannot be sold separately after the sale or securitization of the underlying financial assets. The excess servicing receivable, like normal servicing, will be collected only if the servicing work is performed satisfactorily. In addition, accounting based on that distinction is unduly complex and often results in several assets and liabilities being recognized for one servicing contract. While excess servicing continues to resemble an interest-only strip in some respects, the Board concluded in light of the lessened distinction between normal and excess servicing that it was more useful to account for all servicing assets and servicing liabilities in a similar manner.

198. The Board chose instead to distinguish only between the benefits of servicing—amounts that will be received only if the servicing work is performed to the satisfaction of the assets' owner or trustee—and other amounts retained after a securitization or other transfer of financial assets. A consequence of that method is that interest-only strips retained in securitizations, which do not depend on the servicing work being performed satisfactorily, are subsequently measured differently from servicing assets that arise from the same securitizations. That difference in accounting could lead transferors that retain an interest in transferred assets to select a stated servicing fee that results in larger servicing assets and lower retained interests (or vice versa) with an eye to subsequent accounting. The Board believes, however, that the potential accounting incentives for selecting a higher or lower stated servicing fee largely will counterbalance each other.

199. Most respondents agreed with the Board's decision to eliminate the distinction between excess and normal servicing. Some respondents to the Exposure Draft asked for further explanation of the new terms it used for accounting for servicing and about how they differed from the terminology of the mortgage servicing approach used in prior pronouncements. In response, this Statement defines the terms *adequate compensation* for servicing, *benefits of servicing,* and *contractually specified servicing fees* in the glossary and discusses them more completely in paragraphs 36-38.

200. The Exposure Draft proposed that an entity account for all servicing assets in the same manner because rights to service financial assets, while they may differ in the particulars of the servicing, in the extent of compensation, and in liquidity, are in essence the same. As with other retained interests in transferred assets, valid arguments can be made for measuring servicing assets either at allocated previous carrying amount or at fair value. However, the Board saw no reason to treat retained servicing assets differently than other retained interests and therefore

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decided that they should be initially measured at their allocated previous carrying amount.

201. For similar reasons, the Board viewed servicing liabilities as new obligations arising from a transfer and decided to account for them like other liabilities incurred upon sale or securitization, at fair value.

202. Some respondents questioned how to apply the transition provisions to servicing rights and excess servicing receivables in existence as of this Statement's effective date. The Board considered those comments and as a result decided to change paragraph 20 to (a) not permit retroactive application of this Statement to ensure comparability between entities and (b) clarify how this Statement should be applied to previous balances.

Financial Assets Subject to Prepayment

203. Paragraph 233 of this Statement amends Statement 115 to eliminate the use of the *held-to-maturity* category for securities subject to substantial prepayment risk, thereby requiring that they be classified as either available-for-sale or trading and subsequently measured at fair value. Paragraph 14 extends that measurement principle to interest-only strips, loans, other receivables, and retained interests in securitizations subject to substantial prepayment risk.

204. The justification for using historical-cost-based measurement for debt securities classified as held-to-maturity is that no matter how market interest rates fluctuate, the holder will recover its recorded investment and thus realize no gains or losses when the issuer pays the amount promised at maturity. The same argument is used to justify historical-cost-based measurement for other receivables not held for sale. That justification does not extend to receivables purchased at a substantial premium over the amount at which they can be prepaid, and it does not apply to instruments whose payments derive from prepayable receivables but have no principal balance, as demonstrated by large losses realized in recent years by many holders of interest-only strips and other mortgage derivatives. As a result, the Board concluded that those receivables must be subsequently measured at fair value with gains or losses being recognized either in earnings (if classified as trading) or in a separate component of shareholders' equity (if classified as available-for-sale). The Board, by deciding that a receivable may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the asset would not recover *substantially all* of its recorded investment, left room for judgment, so that investments in mortgage-backed securities or callable securities purchased at an insubstantial premium, for example, are not necessarily disallowed from being classified as held-to-maturity.

205. Some respondents to the Exposure Draft agreed with the Board's conclusions about financial assets subject to prepayment when applied to interest-only strips but questioned the application of those conclusions to loans, other receivables, and retained interests in securitizations. They maintained that the nature of the instrument and management's intent should govern classification rather than actions that a borrower might take under the contract.

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206. The Board did not agree with those arguments. A lender that holds a portfolio of prepayable loans or bonds at par will realize the carrying amount of its investment if the borrowers prepay. However, if the lender originated or acquired those loans or bonds at a substantial premium to par, it may lose some or all of that premium and thus not recover a substantial portion of its recorded investment if borrowers prepay. The potential loss is less drastic for premium loans or bonds than for interest-only strips, but it can still be substantial. The Board concluded that the rationale outlined in paragraph 204 extends to any situation in which a lender would not recover substantially all of its recorded investment if borrowers were to exercise prepayment or other rights granted to them under the contracts. The Board also concluded that the provisions of paragraph 14 do not apply to situations in which events that are not the result of contractual provisions, for example, borrower default or changes in the value of an instrument's denominated currency relative to the entity's functional currency, cause the holder not to recover substantially all of its recorded investment.

207. Other respondents asked that the Board clarify the term *substantially all.* Some suggested that the Board use the 90 percent test found in APB Opinion No. 16, *Business Combinations*. Although applying the term *substantially all* requires judgment about how close to 100 percent is close enough, the Board decided to leave the language of paragraphs 14 and 233 unchanged rather than to require a specific percentage test that would be inherently arbitrary.

Fair Value

208. The Board decided to include an approach for measuring fair value that would be broadly applicable. The definition of fair value in paragraphs 42-44 is consistent with that included in other recent Statements. [18] The Board found no compelling reason to redefine *fair value* under the financial-components approach.

209. Many of the assets and liabilities held after a sale by a transferor with continuing involvement are not traded regularly. Because quoted market values would not be available for those assets and liabilities, fair values would need to be determined by other means in applying the financial-components approach. There was concern that, in some cases, the best estimate of fair value would not be sufficiently reliable to justify recognition in earnings of a gain following a sale of financial assets with continuing involvement, because errors in the estimate of asset value or liability value might result in recording a nonexistent gain. The Board considered requiring that fair value be verifiable to achieve a higher degree of reliability to justify recognition in earnings of a gain following a sale of financial assets with continuing involvement. However, to promote consistency between its Statements, the Board decided not to introduce a new notion of fair value based on reliability.

210. The Exposure Draft proposed that gain recognition following a sale with continuing involvement should be allowed only to the extent that it is practicable to estimate fair values for assets obtained and liabilities incurred in sales with continuing involvement. To accomplish

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that, the Board concluded that if it is not practicable to estimate their fair values, assets should be measured at zero and liabilities at the greater of the amount called for under Statement 5, as interpreted by Interpretation 14, or the excess, if any, of the fair value of the assets obtained less the fair value of the other liabilities incurred over the sum of the carrying values of the assets transferred. That requirement was intended to prevent recognition of nonexistent gains through underestimating liabilities. The Board considered whether the practicability exception should be extended to the transferee's accounting and decided not to allow such an exception. The Board concluded that because the transferee is the purchaser of the assets, it should be able to value all assets and any liabilities it purchased or incurred, presumptively based on the purchase price paid. In addition, because the transferee recognizes no gain or loss on the transfer, there is no possibility of recognizing a nonexistent gain.

211. Respondents to the Exposure Draft asked the Board to clarify the meaning of the term *practicable,* especially in relation to the use of the same term in Statement 107. The comment letters also revealed a considerable range of interpretation of that provision among respondents. Some suggested that the provision would apply to all but the most common transactions. Others suggested that the provision would seldom apply and alluded to the relatively few entities that have used the practicability exception in Statement 107.

212. Because no practicability exception is used, for example, in the June 1996 FASB Exposure Draft, *Accounting for Derivative and Similar Financial Instruments and for Hedging Activities,* the Board considered whether to expand the discussion of practicability, or to remove it from the document. The Board ultimately concluded that the October 1995 Exposure Draft's practicability provisions should remain unchanged in this Statement for the reason noted in paragraphs 209 and 210.

213. Other respondents suggested that this Statement should include a limit on the amount of gain that can be recognized in a transfer of financial assets. Several suggested the limitation found in EITF Issue 88-11. In that Issue, the Task Force reached a consensus that "the amount of any gain recognized when a portion of a loan is sold should not exceed the gain that would be recognized if the entire loan was sold." Respondents maintained that a limitation would meet the Board's objective of preventing recognition of nonexistent gains through underestimating liabilities.

214. The Board rejected the suggested limitation for several reasons. First, it was not clear that the limitation in Issue 88-11 could have been applied across a wide range of transactions. The limitation presumes that a market price exists for transfers of whole assets, but one reason that securitization transactions take place is because sometimes no market exists for the whole assets being securitized. Second, the limitation would have required that accountants ignore the added value that many maintain is created when assets are divided into their several parts. Third, the use of relative fair values at the date of transfer, rather than relative fair values on initial acquisition as in Issue 88-11, would have mitigated many of the concerns that appear to have prompted the Task Force to adopt a limitation. Finally, the Board was concerned that a gain

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limitation might have obscured the need to consider whether the transaction gives rise to a loss.

Subsequent Measurement

215. The provisions of this Statement focus principally on the initial recognition and measurement of assets and liabilities that result from transfers of financial assets. This Statement does not address subsequent measurement except for servicing assets and servicing liabilities and financial assets subject to prepayment.

216. Several respondents to the Exposure Draft asked the Board to include guidance about subsequent measurement in this Statement. They observed that the financial-components approach leads to recognition of assets and liabilities that were not recognized under previous standards. They also observed that accountants who draw analogies to existing accounting practices may find a variety of equally plausible approaches to subsequent measurement.

217. The Board is sensitive to concerns about subsequent measurement, especially to the possibility of emerging diversity in practice. However, attempting to address subsequent measurement would have expanded significantly the scope of this project. In addition, any guidance on subsequent measurement in this project would have applied only to assets and liabilities that emerge from a transfer of financial assets. Accounting for similar assets and liabilities not connected with a transfer of financial assets would have continued to follow existing practice; if so, diversity would have continued to exist. On balance, the Board concluded that it was better to complete this project without providing guidance on subsequent measurement and leave reconsideration of existing standards and practices for subsequent measurement for future segments of the Board's financial instruments project or other projects.

Extinguishments of Liabilities

218. Statement 76 required that a debtor treat a liability as if extinguished if it completed an in-substance defeasance. Under that Statement, a debtor derecognized a liability if it transferred essentially risk-free assets to an irrevocable defeasance trust and the cash flows from those assets approximated the scheduled interest and principal payments of the debt that was being extinguished. Under that Statement, the debtor also derecognized the assets that were set aside in the trust.

219. Derecognition of liabilities after an in-substance defeasance has been controversial. A number of respondents to the Exposure Drafts that led to Statement 76 and subsequent Board requests for comment have criticized the transactions as having insufficient economic substance to justify derecognition or gain recognition. Researchers and analysts have demonstrated that in-substance defeasance transactions conducted after interest rates have risen, which resulted in an accounting gain under Statement 76, have economic impact; those transactions constitute an economic loss to shareholders. [19] That research and analysis suggest that derecognition of liabilities and recognition of a gain in those circumstances may not be representationally faithful.

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220. Under the financial-components approach, an in-substance defeasance transaction does not meet the derecognition criteria for either the liability or the asset. The transaction lacks the following critical characteristics:

a. The debtor is not released from the debt by putting assets in the trust; if the assets in the trust prove insufficient, for example, because a default by the debtor accelerates its debt, the debtor must make up the difference.
b. The lender is not limited to the cash flows from the assets in trust.
c. The lender does not have the ability to dispose of the assets at will or to terminate the trust.
d. If the assets in the trust exceed what is necessary to meet scheduled principal and interest payments, the transferor can remove the assets.
e. Neither the lender nor any of its representatives is a contractual party to establishing the defeasance trust, as holders of interests in a qualifying special-purpose entity or their representatives would be.
f. The debtor does not surrender control of the benefits of the assets because those assets are still being used for the debtor's benefit, to extinguish its debt, and because no asset can be an asset of more than one entity, those benefits must still be the debtor's assets.

221. The Board concluded that the previous treatment of in-substance defeasance was inconsistent with the derecognition criteria of the financial-components approach and that the provisions on in-substance defeasance in Statement 76 should be superseded by this Statement. Respondents to the Exposure Draft generally accepted that change, although some disagreed, citing arguments similar to those made in Statement 76 and refuted, in the Board's view, by the critical characteristics cited in paragraph 220.

222. Paragraph 3(a) of Statement 76 required derecognition of the transferred assets and the liability by the debtor if a debtor transfers assets to its creditor in exchange for a release from all further obligation under the liability. That provision has not been controversial and is consistent with the financial-components approach. Accordingly, paragraph 3(a) of Statement 76 was incorporated substantially unchanged as paragraph 16(a) of this Statement.

223. Paragraph 3(b) of Statement 76 stated, "The debtor is legally released from being the primary obligor under the debt either judicially or by the creditor *and it is probable that the debtor will not be required to make future payments with respect to that debt under any guarantees*" (emphasis added; footnote references omitted). Except for the italicized portion, paragraph 3(b) was carried forward as paragraph 16(b) of this Statement. Some respondents to the Exposure Draft disagreed with that change, arguing that the revised provision was too lenient in that it might allow, for example, derecognition of liabilities and inappropriate gain recognition when entities are replaced as primary obligor by entities with little economic substance. However, the italicized phrase is omitted from this Statement because it is contrary to the financial-components approach. If an entity is released from being a primary obligor and becomes a secondary obligor and thus effectively a guarantor of that liability, it should recognize

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that guarantee in the same manner as a third-party guarantor that was never the primary obligor. The Board noted, however, that concerns about inappropriate gains are unwarranted: if an entity with little substance were to become a primary obligor, a guarantor of that obligation would have to recognize a liability almost as great as if it were the primary obligor. To emphasize those matters, the Board included a discussion of the secondary obligor's liability in Appendix A.

224. The Board concluded that the basic principle that liabilities should be derecognized only if the debtor pays the creditor or is legally released from its obligation applies not just to debt securities but to all liabilities. Accordingly, this Statement broadens the scope of paragraphs 3(a) and 3(b) of Statement 76 to include all liabilities not excluded from this Statement's scope by paragraph 4 and to delete the reference to sales in the public market.

Disclosures

225. The Board decided that this Statement should continue to require disclosure of debt defeased in accordance with Statement 76 before the effective date of this Statement because this Statement does not change the accounting for those defeasance transactions. The Board also decided to require that an entity disclose assets restricted to the repayment of particular debt obligations, for example, in in-substance defeasance transactions after this Statement becomes effective, because while that restriction is insufficient cause to derecognize the assets, that information is useful in determining what resources are unavailable to general creditors and for general operations. The Board decided that an entity should disclose its policies for requiring collateral or other securities in repurchase agreements and securities lending transactions accounted for as borrowings. The Board believes that that information is useful for assessing the amount of risk that an entity assumes in repurchase agreements and securities lending transactions, which appears to vary considerably in practice.

226. The Board also decided to carry forward the disclosures required by Statement 122 and extend them to all servicing rights, because those disclosures provide information financial statement users need to make independent judgments about the value of servicing rights and obligations and the related risks.

227. In addition, the Board decided to require that an entity describe items for which it is impracticable to measure their fair value and disclose why the fair value of an asset obtained or liability incurred could not be estimated, despite the concerns of some Board members that this requirement was unnecessary and might lead to uninformative disclosures.

228. The Board decided that only those additional disclosures should be required because sufficient disclosures are currently in place for transfers and servicing of financial assets, extinguishments of liabilities, and the components resulting from those transfers and extinguishments. For example, transfers of financial assets in exchange for cash must appear in the statement of cash flows, while information about any noncash exchanges must appear in related disclosures, under the provisions of FASB Statement No. 95, *Statement of Cash Flows*.

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The Board also considered various disclosures now required for certain specialized industries by AICPA Guides and other pronouncements and decided that the potential benefits of requiring those disclosures in this Statement did not justify the costs involved.

Effective Date and Transition

229. The Board proposed in the Exposure Draft that this Statement should be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996, and the Board did not change that effective date. While many respondents accepted and some even urged adoption on that date, some respondents expressed concern about the ability to carry out certain of this Statement's provisions by that date, including systems changes needed to keep track of supporting data efficiently. The Board concluded that some of those concerns should be ameliorated by the effects of changes from the Exposure Draft on the accounting for repurchase agreements, securities lending, loan participations, and collateral, and that in other cases data adequate for external financial reporting could be obtained in other ways while systems changes were being completed.

230. The Exposure Draft proposed that this Statement should be applied prospectively to achieve consistency in accounting for transfers of financial assets. That requirement also will ensure that all entities entering into a given transaction report that transaction under the same guidance. If entities were permitted to implement early or implement at the beginning of fiscal years that did not coincide, opportunities might arise to structure transactions in ways that result in the same assets and liabilities being reported in the financial statements of both parties or in the financial statements of neither party. The Board found that possibility undesirable. Most respondents to the Exposure Draft generally accepted that conclusion.

231. The Board also decided that retroactive implementation for all entities was not feasible and that allowing voluntary retroactive implementation was unwise because it would impair comparability of financial statements by permitting disparate accounting treatment for similar transactions reported in previous periods. The Board concluded that those considerations outweighed the lack of consistency within an entity's financial statements for transactions occurring before and after the effective date of this Statement. In addition, the Board concluded that the benefits of retroactive application of the provisions of this Statement would not justify the considerable cost of doing that. Respondents generally accepted that conclusion.

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Appendix C: AMENDMENTS TO EXISTING PRONOUNCEMENTS

232. This Statement supersedes FASB Statements No. 76, *Extinguishment of Debt,* No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse,* and No. 122, *Accounting for Mortgage Servicing Rights,* and FASB Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt,* and No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*.

233. The following sentence is added to the end of paragraph 7 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities:*

> A security may not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment.

234. Paragraph 3(a) of APB Opinion No. 26, *Early Extinguishment of Debt,* as amended by Statement 76, is replaced by the following:

> *Extinguishment of liabilities*. FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* defines transactions that the debtor shall recognize as an extinguishment of a liability.

235. In the last sentence of paragraph 20 of FASB Statement No. 13, *Accounting for Leases,* as amended by Statement 77, the reference to Statement 77 is replaced with a reference to FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.*

236. The last sentence of footnote 1 of FASB Statement No. 22, *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt,* as amended by Statement 76, is deleted.

237. FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* is amended as follows:

a. The second sentence of paragraph 6 that was added by Statement 115 is replaced by the following:

> After the securitization of a mortgage loan held for sale, the mortgage-backed security shall be classified as a trading security.

b. Paragraph 8, as amended by Statement 115, is deleted.

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c. The last sentence of paragraph 9(a) is deleted.

d. In paragraph 10, *(paragraphs 16 through 19)* is deleted and replaced by *(paragraph 13 of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities)*.

e. Paragraph 11 and footnote 4 are deleted.

f. In paragraph 15, the reference to paragraph 18 (as amended by Statement 122) is deleted and the following is added to the end of paragraph 15 replacing the sentence added by Statement 122:

> The rate used to determine the present value shall be an appropriate long-term interest rate. For this purpose, estimates of future servicing revenue shall include expected late charges and other ancillary revenue. Estimates of expected future servicing costs shall include direct costs associated with performing the servicing function and appropriate allocations of other costs. Estimated future servicing costs may be determined on an incremental cost basis. The amount capitalized shall be amortized in proportion to, and over the period of, estimated net servicing income—the excess of servicing revenues over servicing costs.

g. Paragraphs 16-19 and 30 and footnote 6, as amended by Statement 122, are deleted.

h. The three paragraphs added by Statement 122 to paragraph 30 are deleted.

i. In paragraph 34, the terms *current (normal) servicing fee rate* and *servicing* and their definitions are deleted.

238. This Statement carries forward certain amendments that Statement 122 made to Statement 65. Those amendments are:

a. In the first sentence of paragraph 1, *origination or acquisition* is replaced by *purchase or acquisition*.
b. In the first sentence of paragraph 10, *of existing* is replaced by *or origination of.*

239. Paragraph 14(e) of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* is replaced by the following:

> Substantively extinguished debt subject to the disclosure requirements of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

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240. FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* is amended as follows:

a. Paragraph 8(b) of FASB Statement 107 is replaced by the following:

> Substantively extinguished debt subject to the disclosure requirements of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

b. In the last sentence of paragraph 28, *, or the rate that an entity would have to pay to acquire essentially risk-free assets to extinguish the obligation in accordance with the requirements of Statement 76* is deleted.

241. Paragraph 12 of FASB Technical Bulletin No. 86-2, *Accounting for an Interest in the Residual Value of a Leased Asset: Acquired by a Third Party or Retained by a Lessor That Sells the Related Minimum Rental Payments,* is replaced by the following:

> Yes. A residual value of a leased asset is a financial asset to the extent of the guarantee of the residual value. Accordingly, increases to its estimated value over the remaining lease term should be recognized.

242. FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights,* is amended as follows:

a. Paragraphs 1-7 are deleted.

b. Paragraph 9, as amended by Statement 122, is replaced by the following:

> An enterprise may acquire servicing assets or liabilities by purchasing or originating financial assets with servicing rights retained or by purchasing the servicing rights separately. Servicing assets and liabilities are amortized in proportion to, and over the period of, estimated net servicing income—the excess of servicing revenues over servicing costs.

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Appendix D: GLOSSARY

243. This appendix defines terms or phrases used in this Statement.

Adequate compensation
The amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace.

Beneficial interests
Rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be "passed-through" or "paid-through," premiums due to guarantors, and residual interests.

Benefits of servicing
Revenues from contractually specified servicing fees, late charges, and other ancillary sources, including "float."

Cleanup call
An option held by the servicer, which may be the transferor, to purchase transferred financial assets when the amount of outstanding assets falls to a level at which the cost of servicing those assets becomes burdensome.

Collateral
Personal or real property in which a security interest has been given.

Contractually specified servicing fees
All amounts that, per contract, are due to the servicer in exchange for servicing the financial asset and would no longer be received by a servicer if the beneficial owners of the serviced assets or their trustees or agents were to exercise their actual or potential authority under the contract to shift the servicing to another servicer. Depending on the servicing contract, those fees may include some or all of the difference between the interest rate collectible on the asset being serviced and the rate to be paid to the beneficial owners of those assets.

Derecognize
Remove previously recognized assets or liabilities from the statement of financial position.

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Derivative financial instrument

A futures, forward, swap, or option contract, or other financial instrument with similar characteristics (Statement 119, paragraph 5).

Fair value

Refer to paragraphs 42-44.

Financial asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity (Statement 107, paragraph 3(b)).

Financial liability

A contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity (Statement 107, paragraph 3(a)).

Interest-only strip

A contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation, or other interest-bearing financial asset.

Proceeds

Cash, derivatives, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred.

Recourse

The right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables.

Securitization

The process by which financial assets are transformed into securities.

Security interest

A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation.

Seller

A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration.

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Servicing asset

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either (a) undertaken in conjunction with selling or securitizing the financial assets being serviced or (b) purchased or assumed separately.

Servicing liability

A contract to service financial assets under which the estimated future revenues from stated servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

Transfer

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. Thus, a transfer includes selling a receivable, putting it into a securitization trust, or posting it as collateral but excludes the origination of that receivable, the settlement of that receivable, or the restructuring of that receivable into a security in a troubled debt restructuring.

Transferee

An entity that receives a financial asset, a portion of a financial asset, or a group of financial assets from a transferor.

Transferor

An entity that transfers a financial asset, a portion of a financial asset, or a group of financial assets that it controls to another entity.

Undivided interest

Partial legal or beneficial ownership of an asset as a tenant in common with others. The proportion owned may be pro rata, for example, the right to receive 50 percent of all cash flows from a security, or non–pro rata, for example, the right to receive the interest from a security while another has the right to the principal.

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Footnotes

FAS125, Footnote 1--Terms defined in Appendix D, the glossary, are set in **boldface type** the first time they appear.

FAS125, Footnote 2--Contributions—unconditional nonreciprocal transfers of assets—are addressed in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made.*

FAS125, Footnote 3--Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

FAS125, Footnote 4--As a result of that amendment to Statement 115, securities that were previously classified as held-to-maturity may need to be reclassified. Reclassifications of interest-only strips or other securities from held-to-maturity to available-for-sale required to initially apply this Statement would not call into question an entity's intent to hold other debt securities to maturity in the future.

FAS125, Footnote 5--If nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt, the sale and related assumption effectively accomplish a legal release of the seller-debtor for purposes of applying this Statement.

FAS125, Footnote 6--In the case of a partial sale of a financial asset, the transferor generally has reduced the marketability of the asset because it can no longer sell the entire asset—it can only sell part of that asset. Consequently, the partial interest in the original asset has different rights and privileges than those embodied in the original asset and, therefore, is a new asset—different from the original asset.

FAS124, Appendix A, Footnote 7--The description of a special-purpose entity is restrictive. The accounting for transfers of financial assets to special-purpose entities should not be extended to any entity that does not satisfy all of the conditions articulated in this paragraph.

FAS124, Appendix A, Footnote 8--*Scott's Abridgment of the Law on Trusts,* §156 (Little, Brown and Company, 1960), 296.

FAS124, Appendix A, Footnote 9--In this Statement, the term *substantially the same* is used consistently with the usage of that term in the AICPA Statement of Position 90-3, *Definition of*

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the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.

FAS124, Appendix A, Footnote 10--For example, for mortgage loans, financial asset type refers to the various conventional or government guaranteed or insured mortgage loans and adjustable-rate or fixed-rate mortgage loans.

FAS125, Appendix A, Footnote 11--If the "collateral" is a financial asset that the holder is permitted by contract or custom to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the “loaned” securities. To the extent that the "collateral" consists of letters of credit or other financial instruments that the holder is not permitted by contract or custom to sell or pledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee.

FAS125, Appendix A, Footnote 12--Other securities or letters of credit rarely are exchanged in repurchase agreements instead of cash.

FAS125, Appendix B, Footnote 13--FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* par. 119.

FAS125, Appendix B, Footnote 14--Marcia Stigum, *The Repo and Reverse Markets* (Homewood, Ill.: Dow Jones-Irwin, 1989), 313.

FAS125, Appendix B, Footnote 15--*Uniform Commercial Code, Revised Article 8, Investment Securities,* Proposed Final Draft (Philadelphia: American Law Institute, 1994), 18 and 19.

FAS125, Appendix B, Footnote 16--Accounting for repurchase agreements is discussed in paragraphs 66-71.

FAS125, Appendix B, Footnote 17--Statement 65 defined a current (normal) servicing fee rate as "a servicing fee rate that is representative of servicing fee rates most commonly used in comparable servicing agreements covering similar types of mortgage loans." FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights,* clarified what rate a seller-servicer should use as a servicing fee rate as described in Statement 65.

FAS125, Appendix B, Footnote 18--FASB Statements No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* par. 7, and No. 122, *Accounting for Mortgage Servicing Rights,* par. 3(f).

FAS125, Appendix B, Footnote 19--The research referred to includes John R. M. Hand, Patricia

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J. Hughes, and Stephan E. Sefcik, "In-Substance Defeasances: Security Price Reactions and Motivations," *Journal of Accounting and Economics* (May 1990): 47-89; Judy Beckman, J. Ralph Byington, and Paul Munter, "Extinguishment of Debt by In-Substance Defeasance: Managerial Perspectives," *Journal of Corporate Accounting and Finance* (Winter 1989/90): 167-174; Bruce R. Gaumnitz and Joel E. Thompson, "In-Substance Defeasance: Costs, Yes; Benefits, No," *Journal of Accountancy* (March 1987): 102-105; and Abraham M. Stanger, "Accounting Developments: In-Substance Defeasance—Reality or Illusion?" *The Corporation Law Review* (Summer 1984): 274-277.

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