Statement of Financial Accounting Standards No. 77

Note: This Statement has been completely superseded

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FAS77 Summary

Reporting by Transferors for Transfers of Receivables with Recourse

December 1983

Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 77: Reporting by Transferors for Transfers of Receivables with Recourse

FAS 77 Summary

This Statement specifies that a transferor ordinarily should report a sale of receivables with recourse transaction as a sale if (a) the transferor surrenders its control of the future economic benefits relating to the receivables, (b) the transferor can reasonably estimate its obligation under the recourse provisions, and (c) the transferee cannot return the receivables to the transferor except pursuant to the recourse provisions. If those conditions do not exist, the amount of proceeds from the transfer should be reported as a liability.

This Statement is effective for transfers made after December 31, 1983, including those made pursuant to earlier agreements. It amends a minor provision of FASB Statement No. 13, *Accounting for Leases.*

This project was undertaken in response to an Issues Paper prepared by the AICPA and in considering an AICPA Statement of Position, both of which addressed transfers of receivables with recourse. The conclusions of this Statement differ from those reached by the AICPA. It is not expected to change predominant practice generally except that gain or loss on a transfer will be recognized when a transfer is made rather than over the period the receivables remain outstanding.

INTRODUCTION

1. An enterprise may borrow money and pledge receivables as collateral for a loan or may sell receivables with **recourse.** [1] Whether the enterprise pledges or sells the receivables, either the borrower-seller or the lender-purchaser may thereafter bill and collect the receivables, or they may share the servicing of the receivables. Sales of receivables with recourse may have many of the same characteristics as loans collateralized by receivables, and, therefore, the FASB has been asked to clarify the circumstances under which a transfer of receivables with recourse should be recognized by the transferor as a loan or, alternatively, as a sale.

2. In Statement of Position (SOP) 74-6, *Recognition of Profit on Sales of Receivables with*

Recourse, the AICPA addressed profit or loss recognition on receivables sold with recourse (paragraph 16). This Statement reaches a conclusion different from that in SOP 74-6.

SCOPE

3. This Statement establishes standards of financial accounting and reporting by transferors for transfers of receivables with recourse that purport to be sales of receivables. It also applies to participation agreements (that is, transfers of specified interests in a particular receivable or pool of receivables) that provide for recourse, factoring agreements that provide for recourse, and sales or assignments with recourse of leases or property subject to leases that were accounted for as sales-type or direct financing leases.[2]

4. This Statement does not address accounting and reporting by transferees, nor does it address accounting and reporting of loans collateralized by receivables, for which the receivables and the loan are reported on the borrower's balance sheet. It also does not address the accounting and reporting for exchanges of substantially identical receivables or exchanges of other assets.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Transfer Recognized as a Sale

5. A transfer of receivables with recourse shall be recognized as a sale if all of the following conditions are met:

a. *The transferor surrenders control of the future economic benefits embodied in the receivables.* Control has not been surrendered if the transferor has an option [3] to repurchase the receivables at a later date.
b. *The transferor's obligation under the recourse provisions can be reasonably estimated.* Lack of experience with receivables with characteristics similar to those being transferred or other factors that affect a determination at the transfer date of the collectibility of the receivables may impair the ability to make a reasonable estimate of the probable bad debt losses and related costs of collections and repossessions. A transfer of receivables shall not be recognized as a sale if collectibility of the receivables and related costs of collection and repossession are not subject to reasonable estimation.
c. *The transferee cannot require the transferor to repurchase the receivables except pursuant to the recourse provisions.* [4]

6. If a transfer qualifies to be recognized as a sale, all **probable adjustments** in connection

with the recourse obligations to the transferor shall be accrued in accordance with FASB Statement No. 5, *Accounting for Contingencies.* The difference between (a) the sales price (adjusted for the accrual for probable adjustments) and (b) the **net receivables** shall be recognized as a gain or loss on the sale of receivables. If receivables are sold with servicing retained and the stated servicing fee rate differs materially from a **current (normal) servicing fee rate** or no servicing fee is specified, the sales price shall be adjusted to provide for a normal servicing fee in each subsequent servicing period, which shall not be less than the estimated servicing costs.

7. If a transfer qualifies to be recognized as a sale and the sales price is subject to change during the term of the receivables because of a floating interest rate provision, the sales price shall be estimated using an appropriate market interest rate [5] at the transfer date. Subsequent changes in interest rates from the rate used at the transfer date shall be considered changes in the estimate of the sales price and not as interest cost or interest income. The effect shall be reported in income in the period the interest rate changes in accordance with paragraph 31 of APB Opinion No. 20, *Accounting Changes.*

Transfer Recognized as a Liability

8. If any of the conditions in paragraph 5 is not met, the amount of the proceeds from the transfer of receivables shall be reported as a liability.

Disclosures

9. For transfers of receivables with recourse reported as sales, the transferor's financial statements shall disclose [6] (a) the proceeds to the transferor during each period for which an income statement is presented and (b) if the information is available, the balance of the receivables transferred that remain uncollected at the date of each balance sheet presented.[7]

Amendments to Other Pronouncements

10. The reference to SOP 74-6, *Recognition of Profit on Sales of Receivables with Recourse,* is deleted from Appendix A of FASB Statement No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters.* The last sentence of paragraph 20 of FASB Statement No. 13, *Accounting for Leases,* is amended to read as follows:

> Any profit or loss on the sale or assignment shall be recognized at the time of the transaction except that (a) if the sale or assignment is between related parties, the provisions of paragraphs 29 and 30 shall be applied or (b) if the sale or assignment is with recourse, it shall be accounted for in accordance with FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse.*

Effective Date and Transition

11. This Statement shall be effective for transfers of receivables with recourse after December 31, 1983, including transfers after that date that are made pursuant to the terms of earlier agreements. Earlier application of this Statement is encouraged in annual or interim financial statements that have not been previously issued.

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

This Statement was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Messrs. March and Sprouse dissented.

Mr. March and Mr. Sprouse dissent because they believe that a transfer of receivables with recourse, hypothecated receivables, and a loan collateralized by receivables are merely different forms of financing transactions having substantially similar substance. They believe that the proceeds from those transactions, including transfer of receivables with recourse, should be reported initially as liabilities and that the particular form of the transaction should not produce significantly different accounting results. That conclusion is in general agreement with the recommendations of the AICPA in the March 1980 Issues Paper, "Accounting for Transfers of Receivables with Recourse."

Whether an asset of the transferor (the receivables) has or has not been eliminated by a transfer with recourse should depend on whether the "probable future economic benefits" embodied in the asset have in fact been transferred or whether those benefits continue to reside with the transferor. To have an asset, a business enterprise must control its probable future economic benefits to the extent that the enterprise is in a position to receive those benefits to the general exclusion of others. Probable future benefits and related inherent risks cannot be dissociated; bearing related risks is necessarily implicit in controlling future benefits. When a holdback, dealer's reserve, or other arrangement provides adequate protection against loss to the transferee, the economic benefits and inherent risks related to receivables transferred with recourse are controlled by the transferor—that is, the benefits and risks accrue to the transferor to the general exclusion of others. The financial well-being of the transferor is improved by collection; the well-being of the transferee is unchanged. Either the receivables are collected or the transferor makes them good; presumably, the transferee is indifferent as to who pays.

Those circumstances are critically different from the sale of a nonmonetary asset (for example, a manufactured product) with an implied or express warranty. The "probable future economic benefit" embodied in a nonmonetary asset is its service potential—the ability of a truck to provide transportation, a building to provide shelter, a machine to perform a particular function, a product to be resold, and so forth. The purchaser controls the future benefit of a nonmonetary asset to the general exclusion of others to the extent that it alone is in a position of utilizing or failing to utilize that service potential effectively in its attempt to generate future cash flows. The purchaser's future cash flows associated with a nonmonetary asset generally are neither contractually limited nor guaranteed by the seller. Accordingly, it is the financial well-being of the purchaser, not that of the seller, that is primarily affected by the future cash flows associated with nonmonetary assets. If that is not the case, the transfer of a nonmonetary asset also should not be recognized as a sale. For example, FASB Statement No. 48, *Revenue Recognition When Right of Return Exists,* precludes recognition of a "sale" of a product if the purchaser's obligation is contingent on resale, or if the seller has significant obligations for future performance to bring about resale, or if the buyer's obligation to the seller is changed in the event of theft or damage of the product. In those circumstances the financial well-being of the seller is still at stake and a "sale" of its product is not recognized for accounting purposes.

The sheer ability to estimate the amount of product that will not be resold in the future or the amount of transferred receivables that will not be collected in the future is not a sufficient condition to recognize a "sale." The critical question is whose financial well-being—that is, whose future benefits and related inherent risks—is at stake. In the case of transfers of receivables with recourse, the analogy with hypothecated receivables and a loan collateralized by receivables is clear; a sale of product with an implied or express product warranty is readily distinguishable.

That the transferor controls the probable future economic benefits—that is, that the transferor is the primary beneficiary of future benefits and is the bearer of related future risks—seems especially clear if the agreement stipulates that the "sales price" is subject to adjustment due to prepayments by debtors or to a floating interest rate provision. The transferor's retention of credit risk through the recourse provisions and retention of interest rate risk through the floating interest rate provision leave the transferor in a position whose economic substance is indistinguishable from that of a borrower with a floating interest rate loan.

Having concluded that the transfer of receivables with recourse does not trigger the elimination of the transferor's asset, it follows that the receipt of proceeds from the transferee creates a liability on the part of the transferor. As a result of the transaction, the transferor incurs a present obligation for future cash payments to the transferee. The substance of the obligation is the same whether the cash payments are collected primarily from the receivables (if the transferee services the receivables) or entirely from the transferor (if the transferor services the receivables).

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
Victor H. Brown
John W. March
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A: GLOSSARY

12. For purposes of this Statement, certain terms are defined as follows:

Current (normal) servicing fee rate

A servicing fee rate that is representative of servicing fee rates most commonly used in comparable servicing agreements covering similar types of receivables.

Net receivables

The gross amount of the receivables, including finance and service charges and fees owed by the debtor included in the recorded receivables, less related unearned finance and service charges and fees.

Probable adjustments

Adjustments for (a) failure of the debtors to pay when due, for example, estimated bad debt losses and related costs of collections and repossessions accounted for in accordance with Statement 5, (b) estimated effects of prepayments, and (c) defects in the eligibility of the transferred receivables, for example, defects in the legal title of the transferred receivables.

Recourse

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

Appendix B: BACKGROUND INFORMATION

13. Recourse provisions vary. Examples of various forms of recourse provisions include the following:

a. Under some recourse provisions, the transferor must reimburse the transferee in full (by repurchasing the receivable or otherwise) in the event of default by the debtor regardless of whether property that is collateral for the receivable is recovered from the debtor.
b. Under other recourse provisions, the transferee is obligated to repossess property that is collateral for the receivable from the debtor and return it to the transferor before the transferor is compelled to perform under the recourse provisions. Sometimes a recourse provision is effective only if the property is reacquired within a stated period of time, such as 90 days. The recourse provision may require that the transferee sell the repossessed property, apply the proceeds against the balance of the receivable, and charge the transferor

for any remaining receivable balance.

c. Under some recourse provisions, the right of the transferee to demand payment from the transferor is limited to a stipulated maximum dollar amount or percentage of transferred receivables. Depending on the type of receivables transferred and the value of collateral securing the receivables, transfers that appear to be with limited recourse actually might be with full recourse. For example, in the absence of unusual economic conditions or of a material unexpected loss, a recourse provision for an amount in excess of the anticipated loss might assure that the transferee will recover its investment and will suffer no loss from defaults on the receivables.

d. Sometimes the transferee may retain a portion of the transfer price of the receivables until the receivables are collected to ensure performance by the transferor under the recourse provisions. The retained amounts are generally referred to as dealers' reserves or holdbacks, and the terms governing them usually are specified in the transfer agreement. The amount of a dealer's reserve may be determined by the transferee based on previous experience in transactions with the transferor or others. Amounts retained in a dealer's reserve account are sometimes remitted to the transferor as the reserve account exceeds stipulated percentages of the uncollected receivables. Agreements may provide that the dealer's reserve be charged for credit losses if a debtor defaults. Some agreements may limit the transferee's recourse to the transferor to the amount set aside in the dealer's reserve. The holdback is the mechanism by which the recourse provisions in the agreement are effected; they are part of the transfer price and are a receivable of the transferor from the transferee if the transfer qualifies to be recognized as a sale.

14. Sometimes the transferor guarantees the transferee a minimum specified return or profit on the transfer. For example, the transferor guarantees that the transferee will earn 10 percent after deducting all expenses and credit losses. Those arrangements may require the transferor to provide the required yield in addition to repurchasing a defaulted receivable. Prepayments by debtors also might reduce the transferee's yield and require the transferor to pay the difference.

15. The transfer agreement normally stipulates which party is to perform the administration and routine collection functions (usually referred to as "servicing") for the receivables that are transferred. If the transferor retains the servicing function when receivables are sold, the agreement may require the transferee to pay a servicing fee. Even though the agreement does not specifically provide for compensation to the party performing the servicing, compensation for the future servicing will nevertheless be reflected in the transfer price of the receivables.

16. In the early 1970s, the AICPA became concerned about diverse practices in recognizing income on transfers of receivables with recourse. SOP 74-6 was developed to eliminate the use of two different accounting methods by which transferors recognized gains and losses on transfers of receivables with recourse. Some transferors were treating transfers of receivables with recourse as completed transactions and recognizing gains or losses at the time of transfer. Other transferors were deferring gains and recognizing them in income in a systematic manner over the terms of the transferred receivables. Transferors who deferred gains generally

recognized losses immediately at the time of transfer, although some deferred both gains and losses. SOP 74-6 concluded that both gains and losses should be deferred and recognized in income in a systematic manner over the terms of the transferred receivables. SOP 74-6 did not address the presentation of transfers of receivables with recourse in the transferor's balance sheet, which was addressed in an Issues Paper, "Accounting for Transfers of Receivables with Recourse," prepared by the Accounting Standards Division of the AICPA in March 1980. That Issues Paper addressed the types of transfers that should be accounted for as loans and those that should be accounted for as sales. Even though SOP 74-6 was issued in 1974 and the Issues Paper in 1980, the Board was advised that practice continued to be diverse.

17. The Board issued an Exposure Draft of a proposed Statement, *Accounting and Reporting by Transferors for Transfers of Receivables with Recourse,* on November 18, 1981 and received 120 comment letters. Respondents indicated concerns about portions of that Exposure Draft. After considering the comments received, the Board concluded that the Exposure Draft should be revised and reissued for public comment. On August 31, 1982, the Board issued a revised Exposure Draft, *Reporting by Transferors for Transfers of Receivables with Recourse,* with the following principal changes from the November 1981 Exposure Draft:

a. A transfer of receivables with recourse could qualify to be recognized as a sale even though the transfer price is subject to adjustment because of a floating interest rate provision.
b. The "economic substance" criterion contained in paragraph 7(d) of the November 1981 Exposure Draft was not carried forward. That criterion was intended to have the same meaning as that of a similar criterion in FASB Statement No. 48, *Revenue Recognition When Right of Return Exists,* relating primarily to enterprises that exist "on paper," that is, buyers that have little or no physical facilities or employees. It prevents an enterprise from recognizing sales revenue on transactions with parties that the sellers have established primarily for the purpose of recognizing such sales revenue. However, many respondents interpreted the "economic substance" criterion in the November 1981 Exposure Draft as requiring all transfers to a wholly owned unconsolidated finance subsidiary to be reported as loans. Those respondents argued that such reporting effectively would produce results similar to consolidation of the finance subsidiary. The issue of consolidation of finance subsidiaries is beyond the scope of this Statement and will be considered in another project on the Board's agenda addressing consolidation and the equity method of accounting.

The Board received 72 comment letters on the revised Exposure Draft.

Appendix C

BASIS FOR CONCLUSIONS

Paragraph Numbers

Appendix C: BASIS FOR CONCLUSIONS

Introduction

18. This appendix discusses the significant comments received on the revised Exposure Draft and the factors deemed significant by members of the Board in reaching the conclusions in this Statement, including alternatives considered and reasons for accepting some and rejecting others. The Board concluded that it could reach an informed decision on the basis of existing information without a public hearing. Individual Board members gave greater weight to some factors than to others.

Board's Conclusions versus SOP 74-6

19. The conclusions in SOP 74-6 were based on two reasons: (a) transfers of receivables with recourse have many of the same characteristics that collateralized loans have and (b) the transferor's retention of risk through the recourse provision precludes immediate recognition of gain or loss. Those reasons also were used to support the conclusions in the AICPA's March 1980 Issues Paper on transfers of receivables with recourse. Although transfers of receivables with recourse may have many of the same characteristics that collateralized loans have, the Board concluded that a substantive distinction can and should be made between transactions accounted for as sales of receivables with recourse and loans collateralized by receivables. Further, the Board believes that the retention of risk should not automatically disqualify a transaction for recognition as a sale if the retained risk can be reasonably estimated.

Scope

20. Some respondents expressed concern that the concepts of this Statement would be extended in practice to types of transactions not addressed by it, including types of transactions already addressed by other pronouncements. The scope of this Statement is specified by paragraphs 3 and 4. Except as discussed in paragraph 10, this Statement does not modify any of the provisions of any Accounting Research Bulletin, APB Opinion, or FASB Statement and does not apply to transactions for which the accounting or reporting is specified by those pronouncements. In addition, the provisions of other pronouncements apply to transfers of receivables with recourse as appropriate. For example, the requirements for elimination of intercompany gain or loss of ARB No. 51, *Consolidated Financial Statements,* and APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* apply to a transfer of receivables to a finance subsidiary.

Analysis of Transaction

21. In ascertaining whether a transfer of receivables with recourse should be recognized as a loan or a sale, determinations must be made as to (a) the party that controls the future economic benefits embodied in the receivables and (b) each party's rights and obligations resulting from the transfer. To have an asset, a business enterprise must control the future economic benefits embodied in that asset and generally must be able to deny or regulate access to those benefits by others. "The enterprise 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." [8] A seller of receivables with recourse surrenders its control of the related future economic benefits embodied in the receivables, receives cash in exchange for the receivables, and incurs a contractual obligation under the recourse provisions. Sometimes the transferor also acquires a contractual right to receive additional cash or incurs a contractual obligation to pay cash pursuant to the terms of the transfer agreement if the interest rate used to discount the receivables fluctuates subsequent to the transfer date. A borrower retains both the future economic benefits and the risks embodied in the pledged receivables and has an obligation to repay the loan.

Retention of Risk

22. Several respondents stated that the transferor's retention of risk through the recourse provisions should preclude recognizing a transfer of receivables with recourse as a sale. As justification, some of them referred to Statement 48, which specifies how an enterprise should account for sales of its product in which the buyer has a right to return the product. The provisions of Statement 48 were extracted from SOP 75-1, *Revenue Recognition When Right of Return Exists,* without substantive change. Both Statement 48 and SOP 75-1 state six conditions that must be met to recognize revenue at the time of a sale. Neither precludes recognition of a sale merely because some risks are retained, such as credit risk and guarantees of quality. The Board believes that some risk retention by itself is not sufficient to prohibit recognizing a sale. The Board also believes that the basic conclusion of Statement 48 is consistent with the provisions of this Statement. Statement 48 provides that when a right of return exists a seller shall recognize a transaction as a sale only if the amount of future returns can be reasonably estimated. Consistent with that, this Statement requires that the transferor of receivables with recourse must be able to reasonably estimate its obligations under the recourse provisions before the transfer can qualify to be reported as a sale.

23. The Board believes that the uncertainty relating to the transferor's probable future sacrifice under the recourse provisions is similar to the uncertainty relating to a bad debt allowance or to a warranty obligation. Paragraph 23 of Statement 5 states that "inability to make a reasonable estimate of the amount of loss from uncollectible receivables . . . precludes accrual [of the loss] and may, if there is significant uncertainty as to collection, suggest that the installment method, the cost recovery method, or some other method of revenue recognition be used. . . ." Similarly,

paragraph 25 of Statement 5 states that "inability to make a reasonable estimate of the amount of a warranty obligation at the time of sale because of significant uncertainty about possible claims . . . precludes accrual [of the warranty obligation] and, if the range of possible loss is wide, may raise a question about whether a sale should be recorded prior to expiration of the warranty period. . . ." Accordingly, the transfer should not be recognized as a sale if the collectibility of the receivables and related costs of collection and repossession are not subject to reasonable estimation.

24. The Board believes that application of a criterion that retention of risks of ownership automatically precludes reporting a sale would require transferors to report liabilities that do not exist in many instances. Risks retained by the seller should be recognized either by accruing the costs to be incurred or, if those costs are not subject to reasonable estimation, by postponing recognition of the sale. In most transactions, the benefits of ownership can be transferred even though some of the risks of ownership are retained. The Board believes, therefore, that the benefits and risks of ownership are separable. Although recognition of a sale may be postponed because the amount of risk retained cannot be reasonably estimated, that postponement is not because risk is retained per se. Rather, postponing recognition of the sale is prudent reporting in the circumstances because of the significance of the uncertainty of the amount of the obligation for the risk retained. Reporting the sale in one period and the costs of the risk retained in a later period when those costs become reasonably estimable would not provide reliable information about enterprise performance in either period because costs would not be charged against revenues of the period benefited.

Control of Future Economic Benefits

25. Another basic question is whether the probable future economic benefits embodied in the receivables have been disposed of by the transferor. An asset is disposed of if a transaction results in either a loss of its future economic benefits or relinquishing control over the future economic benefits. In a transfer of receivables with recourse, the transferor has received the future economic benefits (cash) relating to the receivables. Accordingly, the significant question is whether the transferor has relinquished control.

26. In considering whether control has been relinquished, paragraph 115 of FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises,* is pertinent. It states in part:

> Every asset is an asset of some entity; moreover, no asset can simultaneously be an asset of more than one entity. . . . To have an asset, a business enterprise must control future economic benefit to the extent that it can benefit from the asset and generally can deny or regulate access to that benefit by others. . . .

To apply that concept to a transfer of receivables with recourse, determining what constitutes control over a receivable is necessary. Although the legal document relating to a transfer of receivables may specify which party has legal title to the related future economic benefits, paragraph 119 of Concepts Statement 3 states that ". . . legal enforceability of a right is not an indispensable prerequisite for an enterprise to have an asset if the enterprise otherwise will probably obtain the future economic benefit involved."

27. One process that might be used to determine who has control is to consider what could happen if interest rates declined subsequent to the date of transfer. The enterprise that controls the receivables could transfer the receivables at a higher price or lower interest rate. Thus, if the transferor has an option to reacquire the receivables at a later date, the transferor would retain an essential characteristic of control of the asset and incur an obligation (a loan).

28. Some respondents suggested that an option to reacquire the receivables at fair value should not preclude sale treatment for a transfer that meets the other criteria in paragraph 5 of this Statement. However, the Board believes that the transferor retains control if it has the right to repurchase the receivables at a later date or to negotiate new favorable changes in the terms of the transfer. Accordingly, the Board believes that such a transfer should not be recognized as a sale.

29. A view has been expressed that the transferor (seller) of receivables remains the primary beneficiary of the future benefits (cash inflows) embodied in the receivables; thus, they remain the transferor's assets. The Board believes that view is not generally observed in accounting. In general business practice, assets are sold subject to implied or express warranty of fitness to perform an intended function—food is fit for human consumption; an automobile is capable of transporting passengers. Receivables are expected to generate cash, which is their only function. A seller benefits when an asset sold performs as intended, for there will be no sacrifice under the warranty. In practice, however, the buyer-owner is considered the primary beneficiary of the future benefits embodied in the asset, including future cash inflows. The Board believes that a logical extension of the concept that the seller is the primary beneficiary of the future benefits would defer recognition of the sale of an asset until it has performed its intended function. It might also suggest that the guarantor of a debt should record a liability and an asset of equal amount until the debtor settles the debt under a theory that the guarantor is the primary beneficiary.

Transferor's Liability to the Transferee

30. In considering whether the transferor is obligated to repay the transfer proceeds, paragraph 28 of Concepts Statement 3 is relevant. That paragraph states:

> 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. [Footnote references omitted.]

Further, Concepts Statement 3 discusses the substantive difference between being primarily obligated and being secondarily obligated for a liability:

> . . . Most liabilities bind a single enterprise or other entity, and those that bind two or more enterprises or other 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. [paragraph 136]
>
> . . . The probability that a secondary or lower ranked obligation will actually have to be paid must be assessed to apply the definition. [paragraph 137]

In a transfer of receivables that qualifies as a sale, the transferor is a guarantor to the extent of the recourse provision and therefore is secondarily obligated. The debtors on the receivables transferred are the primary debtors; the transferor must pay only if the primary debtors do not and only to the extent of the recourse provisions—not the entire amount of proceeds received on receivables transferred.

31. The Board believes that the transferor's probable future sacrifice is limited to the estimated payments under the recourse provisions. The transferor does not have a present obligation to return the transfer proceeds (that is, to repay a loan); rather, the transferor has an obligation to perform under the recourse provisions. To the extent specified by the recourse provisions, the transferor has a contingent liability and, in effect, is a guarantor that the underlying debtors will pay the amounts when due. In that respect, the transferor's obligation is similar to a seller's obligation when there is a right of return (paragraph 22) or to a warranty obligation (paragraph 23).

Transferee's Put Option

32. If the transferee can require the transferor to repurchase the receivables other than through the recourse provisions because of a "put" option, the Board believes that the possibility of the transferee's exercising its option and thereby reversing the transfer creates significant uncertainty about disposition of the receivables by the transferor. A transferee's put option, in the Board's view, therefore requires postponement of recognizing the transfer as a sale.

33. Some respondents disagreed with the Board and indicated that reporting a transfer as a loan if the transferee has a put option is inconsistent because the transferor in fact surrenders control of the asset. They suggested that the transferor should recognize the transfer as a sale and allocate the transfer price between the sale of the receivable and the writing of a put option, with the put option accounted for on a mark-to-market or higher-of-cost-or-market approach. The Board believes that implementing the suggestion to allocate the transfer price between the sale of the receivables and the writing of a put option would depend on the ability to make a reasonable estimate of the value of the put option. Although a put option may have some

characteristics similar to a standby commitment or an interest rate futures contract, factors such as the varying terms and quality of receivables sold, terms of recourse provisions, and a floating interest rate provision in many cases preclude an objective measurement of the value of the put option, and it has no market. Therefore, the Board believes the suggestion is incapable of being implemented and rejected it.

34. Some respondents further suggested that if a transferor desires to avoid reporting a transfer as a sale (for example, to avoid loss recognition), the transferor could include a put option (or a call option) in the transfer agreement solely for that reason with terms to ensure that the option would never be exercised. Paragraph 160 of FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* states that "the quality of reliability and, in particular, of representational faithfulness leaves no room for accounting representations that subordinate substance to form." If respondents were suggesting options without economic substance, the Board believes that professional judgment can eliminate abuses.

Interest Rate Changes

35. Some respondents suggested that a provision for adjustments to the sales price pursuant to a floating interest rate provision creates an unresolved sales price that is subject to the swings of the economy and, therefore, the transfer of receivables should not be recognized as a sale. The Board believes that the issue of the ability to estimate the ultimate sales price is separate from the question of whether a sale took place (asset derecognition). If the transfer qualifies to be recognized as a sale, the Board concluded that the adjustments from changes in interest rates are changes in the estimate of the sales price and should be reported in income in the period the interest rate changes in accordance with paragraph 31 of Opinion 20. [9]

36. A provision for adjustments to the sales price pursuant to a floating interest rate provision is a pricing consideration related to the time value of money. The Board believes that such adjustments do not automatically change the nature of the transaction from a sale to a borrowing but rather that those adjustments arise from a contractual right or contractual obligation created when the transferor and transferee enter into the transfer agreement. Further, the right acquired and the obligation incurred by the transferor are conditional because they require the occurrence of an event (change in interest rate) before the transferor will receive additional cash from the transferee or will pay additional cash to the transferee. Accordingly, the Board concluded that the nature of the transfer does not hinge on whether there is a floating interest rate provision.

Cost-Benefit Considerations

37. In addition to the conceptual reasons for reporting transfers of receivables with recourse as sales, the Board believes that cost-benefit considerations also favor that approach. Established accounting practice for some time has been to report many transfers of receivables with recourse as sales. There is little evidence that financial statements would be more useful if transfers of receivables were reported as collateralized loans rather than sales. On the other hand, the Board

has received a number of indications that modifying current practice to require loan treatment would have significant attendant costs. It has been argued that, at a minimum, many existing transfer agreements (including those with captive finance companies) would have to be revised and that financings might be adversely impacted by requiring loan treatment. While those types of arguments, per se, are not persuasive, they add support to retaining what the Board believes is a conceptually sound accounting method.

Disclosures

38. The Board believes that an enterprise should disclose information about sales of receivables with recourse in its financial statements. A sale of receivables with recourse has the effect of accelerating cash receipts that, in the normal course of collections, would extend over a period of time. In that respect, a sale of receivables with recourse has much the same effect on cash flows as a loan collateralized by receivables. Accordingly, disclosure of the proceeds from transfers of receivables with recourse reported as sales and the balance outstanding would help users of financial statements in assessing the enterprise's ability to generate favorable cash flows, in evaluating its financing activities, and in assessing its liquidity or solvency. The Board chose not to specify the format of the disclosure.

39. Some respondents suggested that the Board should expand the disclosure requirements of this Statement for sales of receivables with recourse to include other disclosures, such as the amount of any contingent liability, significant terms of the transfer agreement and recourse provisions, related party transactions, and so forth. The Board believes that most of those disclosures, if material, are already required by other authoritative pronouncements. The following are examples:

a. Paragraph 12 of Statement 5 requires disclosure of the nature and amount of certain contingencies even though the possibility of loss may be remote. Examples of such contingencies include guarantees to repurchase receivables under recourse provisions (or, in some cases, to repurchase the repossessed property underlying the receivables) and guarantees of a specified return or yield on the transferred receivables, including a floating interest rate provision. Paragraph 17 of Statement 5 also requires disclosure of contingencies that might result in gains.
b. Paragraph 26 of APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions,* requires that the nature and financial effects of a material transaction that occurs infrequently be disclosed as a separate component of income from continuing operations on the face of the income statement or in the notes thereto. A material gain or loss on a sale of receivables with recourse might qualify.
c. Paragraph 33 of Opinion 20 requires disclosure of the effect on income before extraordinary items, net income, and related per share amounts of the current period for a change in estimate that affects several future periods, such as a change in interest rates if the sales price of a sale of receivables with recourse is subject to a floating interest rate provision.

d. Paragraph 2 of FASB Statement No. 57, *Related Party Disclosures,* requires disclosure of material related party transactions, such as a sale of receivables with recourse by a parent company or an affiliate to an unconsolidated finance subsidiary.

This Statement does not alter already existing disclosure requirements. Accordingly, the Board believes that it is unnecessary to duplicate those requirements in this Statement.

Footnotes

FAS77, Footnote 1--Terms defined in the glossary (Appendix A) are in **boldface** type the first time they appear in this Statement.

FAS77, Footnote 2--Refer to FASB Statement No. 13, *Accounting for Leases,* paragraph 6(b), and also paragraph 20, which is amended by this Statement.

FAS77, Footnote 3--A right of first refusal based on a bona fide offer by an unrelated third party ordinarily is not an option to repurchase.

FAS77, Footnote 4--Some transfer agreements require or permit the transferor to repurchase transferred receivables when the amount of outstanding receivables is minor to keep the cost of servicing those receivables from becoming unreasonable. If those reversionary interests are not significant to the transferor, their existence alone does not preclude a transfer from being recognized as a sale.

FAS77, Footnote 5--Paragraph 14 of APB Opinion No. 21, *Interest on Receivables and Payables,* discusses the considerations that may affect the selection of a rate.

FAS77, Footnote 6--As discussed in paragraph 39 of this Statement, other pronouncements also require disclosures about transfers of receivables with recourse. This Statement does not alter those already existing disclosure requirements.

FAS77, Footnote 7--Aggregation of similar transfers may be appropriate for these disclosures.

FAS77, Appendix B, Footnote 8--FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises,* par. 116.

FAS77, Appendix B, Footnote 9--That conclusion is consistent with the Board's conclusion in paragraph 17(b) of Statement 13 as amended by FASB Statement No. 29, *Determining Contingent Rentals,* that a lease having contingent rentals based on the prime interest rate may qualify as a sales-type lease. In such a case, the lease is reported as a sales-type lease with contingent rentals based on the prime rate in effect at the inception of the lease included in minimum lease payments, the present value of which is reported as the sales price. Amounts related to subsequent changes in the prime rate are included in income as they are accruable.