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INTRODUCTION

In June 1996, the Financial Accounting Standards Board (FASB) issued Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Questions of implementation on a new standard are often raised with the FASB staff by preparers, auditors, and others. The staff determined that this Special Report should be issued as an aid in understanding and implementing Statement 125 because of the relatively high number of inquiries received.

The questions and answers in this Special Report are organized by the general topics in Statement 125 to which they relate. Because of the volume and complexity of issues related to implementation of Statement 125, the staff responded in three phases. This third edition of the Special Report is a cumulative document that incorporates both new questions and answers and questions and answers from the first and second editions of the Special Report. (The question-and-answer numbers were revised after the first edition, but not after the second edition.)

The Board currently has a project on its agenda to amend Statement 125. The Board issued an Exposure Draft on that project in the second quarter of 1999. The staff notes that the proposed amendment to Statement 125 could affect several of the questions and answers in this Special Report. However, which questions might be affected cannot be determined until the proposed amendment is completed, and the answers to those questions may not be affected until after the effective date of the amendment. The staff decided to issue the Special Report at this time (and the Board agreed) because the staff believes that the Special Report's guidance will be valuable to constituents in implementing Statement 125.

QUESTIONS AND ANSWERS

Scope

1. Q—If a right to receive the minimum lease payments to be received under an operating lease is transferred, could that right be considered a financial asset within the scope of Statement 125?

   A—No. A right to receive the minimum lease payments to be received under an operating lease is an unrecognized financial asset. As stated in ♦ paragraph 4, Statement 125 "does not address . . . transfers of unrecognized financial assets, for example, minimum lease payments to be received under operating leases."

2. Q—Is a transfer of servicing rights that are contractually separated from the underlying serviced assets within the scope of Statement 125? For example, does Statement 125 apply to an entity's conveyance of mortgage servicing rights that have been separated from an underlying mortgage...

3. **Q**—Is a debtor's conveyance of cash or noncash financial assets in full or partial settlement of an obligation to a creditor a transfer under Statement 125?

**A**—No. A payment of cash or a conveyance of noncash financial assets to the holder of a loan or other receivable in full or partial settlement of an obligation is not a transfer under Statement 125.  

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To explain, a transfer, as defined in ♦ paragraph 243, involves the conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. Conveyances that do not meet the definition of a transfer include the origination of a receivable, the settlement of that receivable, or the restructuring of that receivable into a security in a troubled debt restructuring. A cash payment or conveyance of noncash financial assets from a debtor to a creditor results in full or partial settlement of the creditor's receivable from the debtor. Therefore, the conveyance of assets is not a transfer and, thus, not within the scope of Statement 125's provisions for transfers of financial assets. However, if a noncash financial asset was conveyed to the creditor in full or partial settlement of a creditor's receivable, it would rare to conclude that debt has been extinguished if the criteria of ♦ paragraph 9 were not also met.

4. **Q**—Does Statement 125 address a reacquisition by an entity of its own securities by exchanging noncash financial assets (for example, U.S. Treasury bonds or shares of an unconsolidated investee) for its common shares?

**A**—No. ♦ Paragraph 4 states that "this Statement does not address . . . investments by owners or distributions to owners of a business enterprise" (footnote reference omitted). That scope exclusion applies to both the transferor and the transferee. The transaction in question constitutes a distribution by an entity to its owners, as defined in FASB Concepts Statement No. 6, Elements of Financial Statements, and, therefore, is excluded from the scope of Statement 125.

5. **Q**—Do the provisions of Statement 125 apply to "desecuritizations" of securities into loans or other financial assets?

**A**—Statement 125 does not specifically address the accounting for desecuritization transactions. That issue is addressed by ♦ EITF Topic No. D-51, "The Applicability of FASB Statement No. 115 to Desecuritizations of Financial Assets."

6. **Q**—The deregulation of utility rates charged for electric power generation has caused electricity-producing companies to identify some of their electric power generation operations as "stranded costs." Prior to deregulation, utilities typically expected to be reimbursed for costs through regulation of rates charged to customers. After deregulation, some of these costs may no longer be recoverable through unregulated rates. Hence, such potentially unrecoverable costs often...
are referred to as stranded costs. However, some of those stranded costs may be recovered through a surcharge or tariff imposed on rate-regulated goods or services provided by another portion of the entity whose pricing remains regulated.

Some entities have securitized their enforceable rights to impose that tariff (often referred to as "securitized stranded costs"), thereby obtaining cash from investors in exchange for the future cash flows to be realized from collecting surcharges imposed on customers of the rate-regulated goods or services. Are securitized stranded costs considered to be financial assets, the transfer of which would be within the scope of Statement 125?

A—No. Paragraph 243 defines financial asset as "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" (emphasis added). Therefore, to be a financial asset, an asset must arise from a contractual agreement between two or more parties, not by an imposition of a right by one party on another. Consistent with the notion in Statement 125 and paragraph 39 of FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk, securitized stranded costs are not financial assets, and therefore transfers of securitized stranded costs are not within the scope of Statement 125. Securitized stranded costs are not financial assets because they are imposed on ratepayers by a state government or its regulatory commission and, thus, while an enforceable right, they are not a contractual right to receive payments from another party. To elaborate, while a right to collect cash flows exists, it is not the result of a contract and, thus, not a financial asset. Refer to Question 7.

7. Q—Would a transfer of beneficial interests in a securitization trust that holds nonfinancial assets such as securitized stranded costs or other similar rights by third-party investors be within the scope of Statement 125?

A—Yes. The beneficial interests in a securitization trust that holds nonfinancial assets such as securitized stranded costs or other similar imposed rights would be considered financial assets by the third-party investors, unless a third party must consolidate the trust.

8. Q—Is a judgment from litigation a financial asset?

A—Generally no, but the answer depends on the facts and circumstances. Consistent with the notion in paragraph 39 of Statement 105, a contingent receivable that ultimately may require the payment of cash but does not as yet arise from a contract (such as a contingent receivable for a tort judgment) is not a financial asset. However, when that judgment becomes enforceable by a government or a court of law and is thereby contractually reduced to a fixed payment schedule, the judgment would be a financial asset. To elaborate, if and when the parties agree to payment terms and those payment terms are reduced to a contract, then a financial asset exists.

9. Q—Is a judgment from litigation a financial asset if it is transferred to an unrelated third party (that is, would the transfer be within the scope of Statement 125)?

A—Yes, but only if that judgment is enforceable by a government or a court of law and has been contractually reduced to a fixed payment schedule. Refer to Question 8.

10. Q—Does Statement 125 apply to a transfer of an ownership interest in a consolidated subsidiary by its parent if that consolidated subsidiary holds nonfinancial assets?

A—No. An ownership interest in a consolidated subsidiary is evidence of control of the entity's individual assets and liabilities, not all of which are financial assets, and Statement 125 only...
applies to transfers of financial assets and extinguishments of liabilities. (Note that in the parent's [transferor's] consolidated financial statements, the subsidiary's holdings are reported as individual assets and liabilities instead of as a single investment.)

10A. Q—Assume that a subsidiary is not consolidated by its parent only because it is temporarily controlled. Would Statement 125 apply to the transfer of that parent's investment in its nonconsolidated, temporarily controlled investee?

A—Generally, yes. Investments in subsidiaries that are not consolidated only because control is temporary are accounted for as cost method investments. Transfers of cost method investments are within the scope of Statement 125.

When control over a subsidiary is temporary, the parent will realize its investment by disposing of that investment. The parent will not realize the value of the underlying assets and liabilities through operations. Thus, when control is temporary, the focus is on the investment in the subsidiary's stock, not on the underlying assets and liabilities. Refer to Questions 10 and 10B.

10B. Q—What literature would apply to a transfer of an investment in a controlled entity that has not been consolidated by an entity that accounts for its investments in controlled entities at fair value (for example, a broker-dealer or an investment company)?

A—Statement 125. An entity that carries its investments in subsidiaries at fair value realizes its investments by disposing of them rather than by realizing the values of the underlying assets through operations. Therefore, a transfer of an investment in a subsidiary by that entity is a transfer of the investment (a financial asset), not the underlying assets and liabilities (which might include nonfinancial assets). Refer to Question 10A.

11. Q—Is a transfer of an equity method investment within the scope of Statement 125?

A—Yes, unless the transfer is within the scope of EITF Issues No. 98-7, "Accounting for Exchanges of Similar Equity Method Investments," or No. 98-8, "Accounting for Transfers of Investments That Are in Substance Real Estate."

The definitions of financial asset and financial liability in Statement 125 are based on the definitions of financial asset and financial liability in paragraph 3 of FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments. (Paragraph 3 of Statement 107 defines financial instruments.) Statement 107's definition of financial instruments is derived from the definition of financial instruments in Statement 105. Paragraphs 27 and 42 of Statement 105 identify an equity method investment as a financial instrument.

In Issue 98-7, the EITF reached a consensus that "the exchange of an equity method investment for a similar equity method investment should be accounted for in accordance with [APB] Opinion [No.] 29 [Accounting for Nonmonetary Transactions]." In Issue 98-8, the EITF reached a consensus that "the sale or transfer of an investment in the form of a financial asset that is in substance real estate should be accounted for in accordance with [FASB] Statement [No.] 66 [Accounting for Sales of Real Estate]."

12. Q—Is a forward contract on a financial instrument that must be (or may be) physically settled by the delivery of that financial instrument in exchange for cash a financial asset or liability, the transfer (or extinguishment in the case of a liability) of which would be within the scope of Statement 125?

A—Yes. Under Statement 125, a financial asset is "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” (\* paragraph 243). Statement 125 defines *financial liability* as "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” (\* paragraph 243).

Under those definitions, a forward contract to purchase or sell a financial instrument that must be (or may be) net settled or physically settled by exchanging that financial instrument for cash (or some other financial asset) is a financial asset or liability.

13. **Q**—Is a transfer of a recognized financial instrument that may be a financial asset or a financial liability at any given point in time, such as a forward or swap contract, subject to the provisions of both \* paragraph 9 and \* paragraph 16?

**A**—Yes. Statement 125 provides guidance on transfers of financial assets and extinguishments of liabilities in paragraph 9 and paragraph 16, respectively. Certain recognized financial instruments, such as forward and swap contracts, have the potential to be financial assets or financial liabilities. Accordingly, transfers of those financial instruments must meet the criteria of both paragraph 9 and paragraph 16 to be derecognized.

14. **Q**—Does Statement 125 apply to a transfer of a recognized derivative instrument that is not a financial instrument because delivery of nonfinancial assets is permitted (for example, a commodity contract)?

**A**—The answer depends on the facts and circumstances. If the derivative is a nonfinancial asset at the date of transfer (for example, an option to purchase a commodity), then that transfer is excluded from the scope of Statement 125 because Statement 125 only applies to transfers of financial assets. Notwithstanding, in September 1999, the EITF reached a consensus in \* Issue No. 99-8, "Accounting for Transfers of Assets That Are Derivative Instruments but That Are Not Financial Assets," that transfers of assets that are derivative instruments and subject to the requirements of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, but that are not financial assets should be accounted for by analogy to Statement 125. In contrast, if the derivative is a nonfinancial liability at the date of transfer (for example, a written commodity option), it would be included in the scope of Statement 125 because \* paragraph 16 applies to extinguishments of all liabilities. If the derivative is a nonfinancial instrument that has characteristics of both nonfinancial assets and nonfinancial liabilities (such as a commodity forward contract that is a nonfinancial derivative instrument), then the conditions of paragraph 16 would have to be satisfied to qualify for derecognition because of the potential liability that might arise. [Revised 9/99.]

**Control Criteria**

**Isolation**

15. **Q**—What type of evidence is sufficient to provide reasonable assurance that transferred assets are isolated beyond the reach of the transferor under Statement 125?

**A**—Statement 125 does not provide guidance as to the type and amount of evidence that must be obtained to conclude that transferred financial assets have been isolated from the transferor according to the criterion of \* paragraph 9(a). \* Paragraph 23 states that "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 . . ." (emphasis added). Further, paragraph 23 explains that the nature and extent of support to satisfy this assertion depends on the facts and circumstances of each transaction and...
that all available evidence that either supports or questions an assertion should be considered.

In December 1997, the Audit Issues Task Force Working Group of the AICPA issued an Auditing Interpretation, "The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Statement of Financial Accounting Standards No. 125," to assist auditors in evaluating whether 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.

16. **Q**—Is the requirement of ◆ paragraph 9(a) satisfied if the likelihood of bankruptcy is remote?

**A**—No. The requirement of paragraph 9(a) would not be satisfied simply because the likelihood of bankruptcy of the transferor is determined to be remote. The requirement of paragraph 9(a) focuses on whether transferred assets would be isolated from the transferor in the event of bankruptcy or other receivership regardless of how remote or probable bankruptcy or other receivership is at the date of transfer. ◆ Paragraph 23 explains that "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. . . ."

17. **Q**—Are transferred financial assets isolated from the transferor in those cases in which the Federal Deposit Insurance Corporation (FDIC), acting as receiver for the transferor, has the power to repudiate the contract between the transferor and transferee?

**A**—The answer depends on the facts and circumstances. The impact of that FDIC power is addressed in ◆ EITF Topic No. D-67, "Isolation of Assets Transferred by Financial Institutions under FASB Statement No. 125." That may change as the FDIC proposed in September 1999 a rule that, if adopted, would limit the ability of the FDIC acting as receiver to repudiate certain contracts. [Revised 9/99.]

18. **Q**—Would a transfer from one subsidiary (the transferor) to another subsidiary (the transferee) of a common parent be accounted for as a sale in the transferor subsidiary's separate-company financial statements?

**A**—Yes, if (a) all of the conditions in ◆ paragraph 9 (including the condition on isolation of the transferred assets) are met and (b) the transferee's assets and liabilities are not consolidated into the separate-company financial statements of the transferor. For purposes of applying ◆ paragraph 23 to transfers of financial assets reported in the transferor subsidiary's separate-company financial statements, a transferee is an affiliate of the transferor if the assets and liabilities of both entities are included in the transferor subsidiary's separate-company financial statements. In contrast, if the transferee was an equity method investee of the transferor, only the investment and not the investee's assets and liabilities would be reported in the transferor subsidiary's separate-company financial statements; therefore, the transferee would not be an affiliate for purposes of applying paragraph 23 to the transferor subsidiary's separate-company financial statements.

19. **Q**—If a transferor transfers assets to a trust and receives a note receivable (issued by a third-party investor) in exchange, assuming all of the conditions of ◆ paragraph 9 have been satisfied, would that note receivable represent proceeds from a sale or would it represent a beneficial interest in the transferred assets?

**A**—The answer depends on the nature of the note receivable. If the note receivable is a general obligation of the third-party investor, then it would represent proceeds from a sale. On the other
hand, if the note receivable is solely collateralized by the assets in the trust without recourse to the third-party investor, then, in effect, the note represents a beneficial interest in the transferred assets that would preclude sale accounting pursuant to paragraph 9 to the extent of the beneficial interest retained.

**Conditions That Constrain a Transferee**

20. _Q—_Assuming that all of the other requirements of ♦ paragraph 9 are met, has a transferor surrendered control over transferred assets if the transferee is precluded from exchanging the transferred assets but obtains the unconstrained right to pledge them?

_A—_The answer depends on the facts and circumstances. In a transfer of financial assets, a transferee's right to both pledge and exchange transferred assets suggests that the transferor has surrendered its control of those assets. However, more careful analysis is warranted if the transferee may only pledge the transferred assets. Paragraph 9(b) requires that the transferee obtain the unconstrained right to pledge or exchange the transferred assets. The Board's reasoning for that condition is explained in ♦ paragraph 122, which states that the transferee has obtained control over the transferred assets if it can sell or exchange the transferred assets and, thereby, "obtain all or most of the cash inflows that are the primary economic benefits of financial assets." The transferee can obtain control over the transferred assets through the unconstrained right only to pledge the transferred asset if that right to pledge results in the transferee's obtaining the right to all or most of the related cash inflows from the assets. (Similarly, the transferee also can obtain control over the transferred assets through the unconstrained right only to exchange the transferred asset if that right to exchange results in the transferee's obtaining the right to all or most of the related cash inflows from the assets.)

21. _Q—_In certain loan participation agreements, the transferor is required to approve any subsequent transfers or pledges of the portion of the loans held by the transferee. Would that requirement be a constraint that would prevent the transferee from taking advantage of its right to pledge or to exchange the transferred financial asset and, therefore, preclude accounting for the transfer as a sale?

_A—_The answer depends on the facts and circumstances. ♦ Paragraph 76 explains that "... 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." ♦ Paragraph 25, however, states that "... 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" (emphasis added). Judgment is necessary to determine whether the requirement to obtain the transferor's permission to sell or exchange should preclude sale accounting.

22. _Q—_If a qualifying special-purpose entity (SPE) issues beneficial interests in the form of Rule 144A securities and the holder of those beneficial interests may not transfer them unless an exemption from the 1933 U.S. Securities Act registration is available, do the limits on the transferability of the beneficial interests result in a constraint on the transferee's right to pledge or exchange those beneficial interests and, therefore, preclude sale accounting by the transferor?

_A—_Issuing beneficial interests in the form of Rule 144A securities could limit a holder's ability to transfer those beneficial interests. However, the primary limitation imposed by Rule 144A, that a potential buyer must be a sophisticated investor, would not preclude sale accounting if a large
number of qualified buyers existed so that the holder could transfer those securities and, thereby, realize the full economic benefit of the assets. The answer depends on the facts and circumstances.

**Qualifying Special-Purpose Entities**

23. **Q—**To be considered qualifying, an SPE must have a standing at law distinct from the transferor (paragraph 26(b)) and its activities must be limited permanently by the legal documents that establish it to those activities permitted by paragraph 26(a). However, some SPEs are empowered to sell, exchange, repledge, or distribute transferred assets. What impact, if any, do those powers to sell, exchange, repledge, or distribute have on the qualifying status of the SPE?

**A—**The impact of those powers is addressed in EITF Topic No. D-66, "Effect of a Special-Purpose Entity’s Powers to Sell, Exchange, Repledge, or Distribute Transferred Financial Assets under FASB Statement No. 125."

24. **Q—**Should a securitization transaction be accounted for as a sale if the transferee (that is, an SPE) is required or empowered to sell any or all of the transferred assets? How would a transferor's direct or indirect ability to cause the SPE to sell the transferred assets affect that conclusion?

**A—**Those questions are addressed in Topic D-66.

24A. **Q—**Assume that the risk inherent in a commercial loan portfolio securitized through a qualifying SPE increases because of adverse changes in an industry for which a concentration of loans exists. Can the servicer that also may be a transferor use discretion to select which loans to sell back to itself (or to a third party) at fair value in response to that increased risk or concentration?

**A—**No. A qualifying SPE's powers are restricted to those in paragraph 26 of Statement 125, as interpreted by Topic D-66. A transferor's or servicer's discretion to select which loans to remove to reposition a portfolio is beyond those powers set forth in Statement 125, as interpreted by Topic D-66. Repositioning a portfolio would be a way to maximize return and therefore would violate condition 3 of Topic D-66.

24B. **Q—**Can a bank, insurance company, investment company, pension plan, or other operating entity be a qualifying SPE?

**A—**No. The powers of a qualifying SPE must be restricted to those powers allowed by paragraph 26 as interpreted by Topic D-66. Those entities necessarily engage in activities that require them to have powers beyond those described in paragraph 26 as interpreted by Topic D-66.

25. **Q—**Can an SPE enter into certain types of derivative transactions at the time beneficial interests are issued and still be qualifying?

**A—**Yes, but only if (a) those derivative transactions do not create conditions that violate the...
provisions of paragraph 26 as interpreted by Topic D-66 and (b) the powers of the SPE to enter into derivative transactions are provided for in its legal documents. Refer to Questions 26 and 27.

To illustrate, a qualifying SPE is precluded from entering into written options that provide an opportunity to trigger a condition that enables the SPE to sell transferred assets under circumstances contrary to paragraph 26 as interpreted by condition 2 of Topic D-66.

If an SPE enters into certain derivative transactions, sale accounting is precluded, not because the SPE is not qualifying, but because other provisions of paragraph 9 have not been met. Examples of those transactions include:

- Derivative transactions that would cause the transfer of assets to fail the tests in paragraph 9(c) for a sale
- Derivative transactions that preclude the transferor from achieving legal isolation under paragraph 9(a).

26. Q—Can an SPE be qualifying if it can enter into certain types of derivative transactions subsequent to the time that beneficial interests are issued?

A—As discussed in Question 25, derivative transactions entered into at the inception of the qualifying SPE or at the time the beneficial interests are issued may be permissible under paragraph 26 as interpreted by Topic D-66. In addition, if at any time (including subsequent to the time that beneficial interests are issued) the effect of entering into a derivative violates the conditions of paragraph 26 as interpreted by Topic D-66, the SPE would not be considered qualifying.

27. Q—Paragraph 26 as interpreted by Topic D-66 precludes a qualifying SPE from selling assets with the primary objective of realizing a gain. Alternatively, can an SPE be considered qualifying if it has the power to enter into a derivative contract that, in effect, would result in that SPE's selling assets with the primary objective of realizing a gain or maximizing return?

A—No. All derivative transactions that a qualifying SPE has the power to enter into must be consistent with activities described by paragraph 26, as interpreted by Topic D-66, in order for the SPE to be qualifying. Refer to Questions 25 and 26.

27A. Q—Can a qualifying SPE have the power to sell an asset at a gain as long as the gain does not exceed a loss recognized on an asset sold simultaneously?

A—No. The power of the SPE to sell the asset at a gain violates condition 3 of Topic D-66 and thus causes it to not be qualifying. A transferor should consider the powers of an SPE individually when applying Topic D-66.

28. Q—Can an SPE that is permitted to hold title to nonfinancial assets temporarily as a result of foreclosing on financial assets be considered qualifying?

A—Yes. Servicing of assets is a permitted activity for qualifying SPEs under paragraph 26(a). Paragraph 35 indicates that servicing includes executing foreclosure if necessary. Therefore, an SPE that holds title to nonfinancial assets temporarily as a result of executing foreclosure on financial assets in connection with servicing can be considered qualifying.

28A. Q—Can an SPE that holds an investment accounted for under the equity method be qualifying?

A—No. Entities account for an investment in accordance with the equity method when they have the ability to exercise significant influence over that investment as described by paragraph 17 of...
APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. Paragraph 17 of Opinion 18 explains that "the ability to exercise significant influence . . . may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency." Those activities would require that an SPE have powers beyond the permitted powers of a qualifying SPE set forth in paragraph 26 as interpreted by Topic D-66. Therefore, an SPE that holds an investment accounted for under the equity method is precluded from being qualifying. Refer to Question 39A.

29. **Q**—Credit card securitizations often include a "removal-of-accounts" provision that permits the seller, under certain conditions and with trustee approval, to withdraw receivables from the pool of securitized receivables. Does a transferor's right to remove receivables from a credit card securitization preclude accounting for a transfer as a sale?

**A**—For now, the impact of a removal-of-accounts provision on a transfer of financial assets subject to the provisions of Statement 125 should continue to be based on the guidance in EITF Issue No. 90-18, "Effect of a 'Removal of Accounts' Provision on the Accounting for a Credit Card Securitization." That Issue is being reconsidered in connection with the proposed amendment of Statement 125. The provisions of Issue 90-18 should be applied only to revolving-period securitization transactions that meet its criteria. Those provisions should not be analogized to other types of transactions.

30. **Q**—If a transferor's retention of beneficial interests in non-readily-obtainable assets transferred to an SPE permits the transferor to dissolve the SPE and reassert control of the assets, is the transferor precluded from accounting for the transfer as a sale?

**A**—Yes, because the transferor maintains effective control over the transferred assets through its right to dissolve the qualifying SPE and to reclaim the transferred assets. Two conditions of paragraph 9 may not have been met in this scenario. First, the SPE would not be considered qualifying if it does not have a distinct standing at law as required by paragraph 26(b). That paragraph explains that,

"...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 reassert control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it." In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity. [Reference omitted.]

Second, the transferor effectively has an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable. Such an agreement would preclude sale accounting pursuant to paragraph 9(c)(2).

31. **Q**—Can a fixed-maturity debt instrument, a commercial paper obligation, or an equity interest be considered a beneficial interest in a qualifying SPE?

**A**—Yes. Paragraph 49 states that "...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." Paragraph 127 explains that:

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.
Q—Can a qualifying SPE "assume" the obligations of a transferor or the obligations of some other entity?

A—While assuming the debt of another entity is not specifically among the permitted activities of a qualifying SPE as described in paragraph 26, paragraph 26(a)(2) states that an SPE can issue beneficial interests, including those in the form of debt securities or equity securities, and be considered qualifying. Paragraph 243 defines beneficial interests as:

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.

If a lender legally releases the transferor from being the primary obligor under a liability assumed by an SPE, the lender is, in fact, accepting a beneficial interest in the assets held by that SPE in exchange for the loan it previously held. Therefore, a qualifying SPE can issue beneficial interests in the transferred financial assets that it holds to a lender and, in effect, assume or "incur" a debt obligation. An example of such an assumption by a qualifying SPE is found in Question 33.

Q—May a debtor derecognize a liability if it transfers noncash financial assets to a qualifying SPE that "assumes" the liability?

A—Yes, but only if the liability is considered extinguished under paragraph 16 and the transfer of the noncash financial assets is accounted for as a sale under paragraph 9.

A debtor may derecognize a liability if and only if it has been extinguished. Paragraph 16 states that a liability has been extinguished if either of the following two conditions is met:

• The debtor pays the creditor and is relieved of its obligation for the liability.
• The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

The transfer of assets to a qualifying SPE would not, in most cases, constitute a payment to the creditor and, therefore, would not meet the condition in paragraph 16(a) of Statement 125. However, the debtor may extinguish its liability if, as a result of transferring the assets to the qualifying SPE, the debtor is legally released from being the primary obligor under the liability according to paragraph 16(b) of Statement 125. If the creditor's legal release is not obtained, the debtor should continue to recognize the obligation.

A debtor that is legally released from being the primary obligor by the transfer of noncash financial assets may, nevertheless, be required to recognize another, similar liability if it continues to recognize those noncash financial assets that were transferred to the qualifying SPE. According to the provisions of paragraph 12 of Statement 125:

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).

If all of the conditions of paragraph 9 are not met for the transfer of noncash financial assets to the SPE (for example, because the SPE is not qualifying and the provisions of paragraph 9(b)(1) are not met), the entity will continue to recognize those assets. That also will result in the entity's recording an obligation to pass through the cash flows from those transferred assets to the qualifying SPE.
34. Q—Can a qualifying SPE simultaneously be a conduit for separate (that is, no commingling or cross-collateralization) securitizations from more than one transferor? In other words, can a "condominium structure" be a qualifying SPE?

A—Yes, as long as the restrictive criteria of paragraph 26, as interpreted by Topic D-66, are met. That guidance does not prohibit a qualifying SPE from acting as a conduit for more than one securitization transaction, even if the individual "condominiums" (which are sometimes referred to as "silos") hold dissimilar financial assets.

35. Q—In what circumstances should a qualifying SPE be consolidated by the transferor?

A—EITF Issue No. 96-20, "Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities," discusses the circumstances in which a qualifying SPE should be consolidated by the transferor. Subsequently, EITF Issue No. 97-6, "Application of Issue No. 96-20 to Qualifying Special-Purpose Entities Receiving Transferred Financial Assets Prior to the Effective Date of FASB Statement No. 125," modified the transition requirements of Issue 96-20.

In all other circumstances, EITF Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions," and EITF Topic No. D-14, "Transactions involving Special-Purpose Entities," should be applied, as appropriate, to determine whether a qualifying SPE should be consolidated. 6(7)

35A. Q—Should a transferor apply Issue 96-20 when determining whether to consolidate a qualifying SPE if some or all of the transfers of financial assets to that SPE are accounted for as secured borrowings under paragraph 9?

A—Yes, assuming that all of the scope criteria of Issue 96-20 have been satisfied. Once the transferor establishes that its qualifying SPE is within the scope of Issue 96-20, the conditions for sale accounting in paragraph 9 are irrelevant to determining whether a qualifying SPE is consolidated. Issue 96-20 states:

This issue is limited to the consolidation of "qualifying SPEs" (as defined in Statement 125) by transferors when all transfers of financial assets to the SPEs have been accounted for under Statement 125 as sales, secured borrowings, or transfers in exchange for beneficial interests in the transferred assets.

One possible outcome of applying Issue 96-20 to a qualifying SPE that holds transferred financial assets that were accounted for as secured borrowings by the transferor is that the qualifying SPE would not be consolidated and the transferred assets held by the qualifying SPE would remain on the books of the transferor because the conditions for sale accounting have not been met.

36. Q—Should the provisions of Issue 96-20 be applied by an entity other than the transferor of financial assets in deciding whether to consolidate a qualifying SPE that holds those transferred assets?

A—No. Issue 96-20 "is limited to the consolidation of 'qualifying SPEs' (as defined in Statement 125) by transferors [that is, not a sponsor or creator if it is not also the transferor] when all transfers of financial assets to the SPEs have been accounted for under Statement 125 as sales, secured borrowings, or transfers in exchange for beneficial interests in the transferred assets" (emphasis added).

The EITF also reached a consensus that in all other circumstances, a transferor (or sponsor or creator, as applicable) should continue to apply the consolidation criteria of Topic D-14 and Issue 90-15, as appropriate.
37. **Q**—If a transferor was to subsequently transfer all the equity interests in a previously unconsolidated qualifying SPE to an unrelated third party, would that third party be able to use Issue 96-20 as its basis for evaluating consolidation accounting?

**A**—No. Issue 96-20 "is limited to the consolidation of 'qualifying SPEs' (as defined in Statement 125) by transferors when all transfers of financial assets to the SPEs have been accounted for under Statement 125 as sales, secured borrowings, or transfers in exchange for beneficial interests in the transferred assets" (emphasis added).

38. **Q**—Assume that an entity transfers financial assets to a qualifying SPE in a transaction that meets the criteria for sale accounting. Should the transferor consolidate the qualifying SPE if it retains more than 50 percent of the beneficial interests issued by the qualifying SPE?

**A**—The transferor should apply the provisions of Issue 96-20 in deciding whether to consolidate the qualifying SPE. The transferor's retention of more or less than 50 percent of the beneficial interests in a qualifying SPE does not affect that decision. However, under paragraph 10(a) of Statement 125, the transferor will "continue to carry in its statement of financial position any retained interest in the transferred assets..." In accordance with paragraph 33, those retained interests "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." Paragraph 33 adds: "That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales."

39. **Q**—Does Issue 96-20 apply to an SPE if the assets that are transferred to the SPE are nonfinancial?

**A**—No. Issue 96-20 only applies to the consolidation of qualifying SPEs. An SPE that receives nonfinancial assets (for example, real estate or stranded costs) in a transfer is not qualifying.

The provisions of Issue 96-20 also do not apply to qualifying SPEs that hold financial assets that, through a structured transaction or a series of transactions, resulted from the conversion of nonfinancial assets to those financial assets.

39A. **Q**—Assume that Company A holds a 30 percent ownership interest in Company B. Company A sells 5 percent of that interest in Company B to a qualifying SPE, thereby reducing its interest to 25 percent. Before and after the transfer, Company A accounts for its ownership interest in Company B under the equity method. Criterion 2 of Issue 96-20 states, "The assets held by the qualifying SPE are financial assets, such as receivables from credit cards, mortgage loans, or securities, that represent a contractual right to cash (or another financial instrument) from, or an ownership interest in, an entity that is unrelated to the transferor" (emphasis added). Would Company A be precluded from applying the consolidation guidance in Issue 96-20 to that qualifying SPE? Would it make a difference if Company A's ownership interest in Company B is reduced down to a level such that the investment is no longer accounted for under the equity method after the transfer?

**A**—Yes and no, respectively.

Yes, Company A is precluded from applying the consolidation guidance in Issue 96-20 to that qualifying SPE. Company A should apply the consolidation guidance in Topic D-14 or Issue 90-15, as appropriate. FASB Statement No. 57, Related Party Disclosures, defines related parties as "affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise..." (emphasis added). Company B, therefore, is an entity related to Company A, so Criterion 2 of Issue 96-20 has not been met.
No, the level of Company A's ownership interest subsequent to the transfer would not make a difference even if reduced to a level such that the investment in Company B is no longer accounted for under the equity method following the transfer (and even if reduced to zero). Criterion 2 considers the level of ownership interest at the time of the transfer, not subsequent to the transfer.

40. **Q**—Could a transferor apply the special consolidation provisions of ♦ Issue 96-20 to a qualifying SPE that holds financial assets that are the result of a conversion of nonfinancial assets into a financial asset as the result of a structured transaction (or a series of transactions)?

**A**—No. Under Issue 96-20, three criteria must be met by a qualifying SPE for the transferor to qualify for its special consolidation provisions. Criterion 3 of Issue 96-20 states that financial assets held by the qualifying SPE cannot be "the result of a structured transaction (or a series of transactions) that has the effect of (a) converting nonfinancial assets, for example, real estate or servicing assets, into a financial asset or (b) recognizing previously unrecognized financial assets." In all other circumstances, the transferor should apply the consolidation criteria of ♦ Topic D-14 and ♦ Issue 90-15, as appropriate.

**Effective Control**

41. **Q**—Dollar-roll repurchase agreements (also called dollar rolls) are agreements to sell and repurchase similar but not identical securities. ♦ Paragraph 9(c)(1) precludes sale accounting for a dollar-roll transaction that is subject to the provisions of Statement 125?

**A**—A transfer of financial assets under a dollar-roll repurchase agreement is within the scope of Statement 125 if that agreement arises in connection with a transfer of existing securities. In contrast, dollar-roll repurchase agreements for which the underlying securities being sold do not yet exist or are to be announced (for example, TBA GNMA rolls) are outside the scope of Statement 125 because those transactions do not arise in connection with a transfer of recognized financial assets. In those cases, other existing literature should be applied. For example, the provisions of ♦ EITF Issue No. 84-20, "GNMA Dollar Rolls," apply to what are considered Type 4 securities by that Issue.

42. **Q**—Does ♦ paragraph 9(c)(1) preclude sale accounting for a dollar-roll transaction that is subject to the provisions of Statement 125?

**A**—The answer depends on the facts and circumstances. For paragraph 9(c)(1) to preclude sale accounting, pursuant to ♦ paragraph 27(a), "the assets to be repurchased or redeemed [must be] the same or substantially the same as those transferred." ♦ Paragraph 28 describes six characteristics that must all exist in order for a transfer to meet the substantially-the-same requirement in paragraph 27(a). One of those characteristics is that the same aggregate unpaid principal amount or principal amounts within accepted "good-delivery" standards for the type of security involved must be met. However, the good-delivery standard is only one of the six characteristics that must exist. Therefore, it is likely that some dollar rolls that meet the good-delivery standard will fail to meet the substantially-the-same requirement.

43. **Q**—In a transfer of existing securities under a dollar-roll repurchase agreement, if the transferee is committed to return substantially-the-same securities to the transferor but that transferee's securities were TBA (to be announced) at the time of transfer, would the transferor be precluded

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Superseded by the FASB Accounting Standards Codification on July 1, 2009.
A—No. For transfers of existing securities under a dollar-roll repurchase agreement, the transferee must be committed to return substantially-the-same securities to the transferor to fail the condition in paragraph 9(c)(1) that would preclude sale accounting. The asset to be returned may be TBA at the time of the transfer because the transferor would have no way of knowing whether the transferee held the security to be returned. That is, the transferor is only required to obtain a commitment from the transferee to return substantially-the-same securities and is not required to perform due diligence to determine that the transferee holds the securities that it has committed to return.

44. Q—Paragraph 29 states that "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." Would the requirement of paragraph 9(c)(1) preclude sale accounting by the transferor if, under the arrangement, the transferor is substantially overcollateralized at the date of transfer even though the arrangement does not provide for frequent adjustments to the amount of collateral maintained by the transferee?

A—No. A mechanism to ensure that adequate collateral is maintained must exist even in transactions that are substantially overcollateralized (for example, "deep discount" and "haircut" transactions) for paragraph 9(c)(1) to preclude sale accounting for those transactions. Even if the probability of ever holding inadequate collateral appears remote, as explained in paragraph 29, the requirement of paragraph 9(c)(1) would not be met and sale accounting by the transferor would not be precluded if there is no method of assuring that the collateral is sufficient "at all times . . . to fund substantially all of the cost of purchasing replacement assets from others." Refer to EITF Topic No. D-65, "Maintaining Collateral in Repurchase Agreements and Similar Transactions under FASB Statement No. 125," for additional information.

45. Q—Paragraph 29 requires that "...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" (emphasis added). Substantially all is not specifically defined in Statement 125. Should entities analogize to APB Opinion No. 16, Business Combinations, and interpret substantially all to mean 90 percent or more?

A—No. The Board elected not to define substantially all because, as explained in paragraph 152, "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." Paragraph 152 further states that . . . 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.

Judgment should be applied based on the facts and circumstances.

46. Q—Does Statement 125 contain special provisions for differences in collateral maintenance requirements that exist in markets outside the United States?

A—No. The general provisions of Statement 125 apply. Market practices and contracts for
repurchase, sale-buy backs, and securities lending transactions can vary significantly from market to market and country to country. However, sale accounting is precluded by paragraph 9(c)(1) only if the transfer involves an agreement that both entitles and obligates the transferor to repurchase or redeem the assets before maturity and all of the requirements of paragraphs 27-29 are met.

For example, in certain markets, it is not customary to provide or maintain collateral in connection with repurchase transactions. In addition, in emerging market repurchase agreements, the amount of cash lent often is limited to an amount substantially less than 100 percent (for example, 80 percent or less) of the value of the securities transferred under the repurchase agreements because of the level of market and credit risk associated with those transactions. Statement 125 does not provide special provisions for those differences in collateral requirements and, as a result, sale accounting would not be precluded by paragraph 9(c)(1) for those transactions.

47. Q—Paragraph 9(c)(1) of Statement 125 states that a transferor has surrendered control over transferred assets if it does not maintain effective control over the transferred assets through "an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity" (emphasis added). What does the term before maturity mean in the context of the transferor maintaining effective control under the provisions of Statement 125?

A—Statement 125 does not specifically define the term before maturity. However, in describing whether a transferor maintains effective control over transferred assets through a right and obligation to repurchase, paragraph 147 states that "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." A transferor's agreement to repurchase a transferred asset would not be considered a repurchase or redemption before maturity if, because of the timing of the redemption, the transferor would be unable to sell the asset again before its maturity (that is, the period until maturity is so short that the typical settlement is a net cash payment).

48. Q—In certain transactions, the transferor is entitled to repurchase a transferred amortizing, individual financial asset that is not readily obtainable elsewhere when its remaining principal balance reaches some specified amount, for example, 30 percent of the original balance. Does Statement 125 permit such a transfer to be accounted for partially as a sale and partially as a secured borrowing (that is, account for 70 percent of the asset as sold and 30 percent as a retained interest)?

A—No. Statement 125 does not permit a transferred amortizing, individual financial asset to be bifurcated in the manner described. Under paragraph 9(c)(2), a call on not-readily-obtainable assets before their maturity results in the transferor's maintaining effective control over the transferred assets and, therefore, precludes sale accounting. However, other factors also must be considered. For example (assuming the retained interest was a specified percentage much smaller than described in the question), sale accounting would not necessarily be precluded by a servicer's right to repurchase the transferred assets if that right represents a cleanup call. Additionally, if the transferor retains a call option to repurchase a few specified, individual loans of an entire portfolio of not-readily-obtainable loans that were transferred in the securitization transaction, then sale accounting would be precluded only for the specified loans subject to the call, not the whole portfolio of loans.

49. Q—Would a transferor's contractual right to repurchase a loan participation that is not a readily obtainable asset preclude sale accounting?
Yes. As explained in paragraph 76, a loan participation can only be accounted for as a sale if all of the criteria in paragraph 9 are met. Paragraph 9(c)(2) precludes sale accounting for transfers that include "an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable. . . ."

Q—In certain industries, a typical customer's borrowing needs often exceed its bank's legal lending limits. In order to accommodate the customer, the bank may "participate" the loan to other banks (that is, transfer under a participation agreement a portion of the customer's loan to one or more participating banks). In those situations, a noncontractual understanding may exist among the participants. Under that noncontractual understanding, the participating banks will return some portion of the loan at par to the lending bank if its legal lending limit increases. The noncontractual understanding is not an enforceable right, although the participating banks generally comply. Those loans generally are not-readily-obtainable assets, and the participating banks are not constrained from selling their interest in the participation. Does this noncontractual understanding constitute a call on not-readily-obtainable assets?

A—No. A probable behavior is not equivalent to a contractual right. Paragraph 9(c)(2) focuses on a transferor's right (it is phrased entitles) to repurchase or redeem the transferred assets. Therefore, while in most circumstances the transferee will likely return the assets if the transferor asks for them, it is not obligated to do so. That is, the transferor has not retained control over the transferred assets if it does not have a legal right to call those assets.

Q—Under Statement 125, does a transfer of a debt security classified as held-to-maturity that occurs for a reason other than those specified in paragraphs 8 and 11 of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, taint the entity's held-to-maturity portfolio?

A—The answer depends on the accounting for the transfer. If the transfer of a held-to-maturity debt security is accounted for as a sale under Statement 125 and it is transferred for a reason other than those specified in paragraphs 8 and 11 of Statement 115, then the transfer would taint the held-to-maturity portfolio. However, if the transfer is accounted for as a secured borrowing, then the transfer would not taint the held-to-maturity portfolio.

Whether a transfer of a debt security is accounted for as a sale under Statement 125 depends on whether the criteria in paragraph 9 are met. In repurchase transactions involving readily obtainable held-to-maturity debt securities, the criteria set forth in paragraphs 27-29, which are an integral part of paragraph 9, must be carefully evaluated to determine whether the transaction should be accounted for as a sale or secured borrowing. For example, if the security that is required to be returned has a different maturity or has a different contractual interest rate from the transferred security, the substantially-the-same criterion would not be met. In that case, effective control would not be maintained under paragraph 9(c) and the transfer would be accounted for as a sale assuming the conditions in paragraphs 9(a) and 9(b) are met.

Q—What is the accounting for transfers in which a call option is "embedded" in beneficial interests issued by a qualifying SPE?

A—For now, SEC registrants should follow the guidance in EITF Topic No. D-63, "Call Options 'Embedded' in Beneficial Interests Issued by a Qualifying Special-Purpose Entity," which addresses the effect on the accounting for transfers in which a call option is "embedded" in beneficial interests issued by a qualifying SPE and those beneficial interests are not readily obtainable elsewhere. That guidance also applies to instances in which the embedded call is attached to transferred financial assets, rather than beneficial interests, that are not readily obtainable elsewhere. That guidance is not applicable to call options that are the subject of Issue
53. **Q**—Assuming that all of the other criteria of paragraph 9 are met, is sale accounting appropriate if a cleanup call on not-readily-obtainable assets is held by a party other than the servicer? For example, sometimes the fair value of beneficial interests retained by a transferor of financial assets who is not the servicer is adversely affected by the amount of transferred financial assets declining to a "low level." In that case, could the transferor retain a cleanup call?

**A**—No. Paragraph 243 defines a cleanup call as "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." Therefore, the transferor's call on the not-readily-obtainable assets is not a cleanup call, and sale accounting is precluded regardless of the amount (for example, a call on 1 percent of the assets). However, if the call was on specific individual assets, as opposed to some percentage of the entire portfolio of transferred assets as contemplated by the question, then only the assets subject to the call option would be precluded from sale accounting. Further, Topic D-66 provides guidance as to whether a call option held by someone other than the transferor or servicer precludes sale accounting.

54. **Q**—In a securitization transaction involving not-readily-obtainable assets, may a transferor that is also the servicer hold a cleanup call if it "contracts out the servicing" to a third party (that is, enters into a subservicing arrangement with a third party) without precluding sale accounting?

**A**—Yes. Under a subservicing arrangement, the transferor remains the servicer from the perspective of the qualifying SPE because the qualifying SPE does not have an agreement with the subservicer (that is, the transferor remains liable if the subservicer fails to perform under the subservicing arrangement). However, if the transferor sells the servicing rights to a third party (that is, the agreement for servicing is between the qualifying SPE and the third party subsequent to the sale of the servicing rights), then the transferor could not hold the cleanup call without precluding sale accounting.

**Measurement of Assets and Liabilities upon Completion of a Transfer**

55. **Q**—Could a transferor's exchange of one form of beneficial interests in financial assets that have been transferred into a trust for an equivalent, but different, form of beneficial interests in the same transferred financial assets be accounted for as a sale under Statement 125?

**A**—No. Not only would this exchange not be a sale, it might not even be a transfer under Statement 125. If the exchange described is with the trust that initially issued the beneficial interests, then the exchange is not a transfer under Statement 125. Paragraph 243 defines transfer as "the conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset." If the exchange is not a transfer, then the provisions of paragraph 10 would not be applied to the transaction.

56. **Q**—How should the transferred and retained components of financial assets be accounted for upon completion of a transfer?

**A**—Upon completion of a transfer, the transferor continues to carry any retained interests in the transferred assets, including servicing assets, beneficial interests in assets transferred to a qualifying SPE in a securitization, and retained undivided interests, in its statement of financial position pursuant to paragraph 10. That paragraph also requires that the transferor 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. Paragraph 11 requires that assets obtained and
liabilities incurred in consideration as proceeds of a sale be recognized at fair value unless it is not practicable to do so.

Retained interests and assets obtained and liabilities incurred upon completion of a transfer of financial assets should be recognized separately. Statement 125 focuses "principally on the initial recognition and measurement of assets and liabilities that result from transfers of financial assets. [Statement 125] does not address subsequent measurement except for servicing assets and servicing liabilities and financial assets subject to prepayment" (paragraph 215). Therefore, other assets and liabilities recognized upon completion of a transfer should be subsequently measured according to other existing accounting pronouncements and related guidance. For example:

• Servicing assets and liabilities should be initially recognized in accordance with paragraphs 37(a), 37(b), and 37(d) and subsequently measured in accordance with paragraphs 37(f)-37(h).
• 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 should be initially recognized according to paragraphs 10 and 11 and, pursuant to paragraph 14, subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended by Statement 125.
• Equity securities that have readily determinable fair values and debt securities should be initially recognized according to paragraphs 10 and 11 and subsequently measured in accordance with FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities, and Statement 115, as applicable.
• Derivative financial instruments should be initially recognized at fair value (according to paragraph 31) and subsequently measured in accordance with existing accounting pronouncements and related guidance on derivative instruments.

Q—How does a transferor account for a beneficial interest in transferred financial assets if it cannot determine whether that beneficial interest is a new asset or a retained interest?

A—Paragraph 33 states that "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." Paragraph 31 further states that "all proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable."

Q—In certain securitization transactions, more than one transferor contributes assets to a single qualifying SPE. Those transactions are sometimes referred to as securitization transactions that "commingle" assets. For example,

Transferor A transfers a Treasury bond and Transferor B transfers a zero-coupon corporate bond to the same qualifying SPE. At the date of the transfers, the fair value of the Treasury bond and the zero-coupon corporate bond are equal. In exchange, each transferor receives a 50 percent beneficial interest in the qualifying SPE entitling each participant to a 50 percent undivided interest in each cash flow (that is, each beneficial interest holder receives the same tranche of the trust certificates and is entitled to 50 cents of each dollar collected).

What is the basis for determining whether a beneficial interest in transferred financial assets is a new asset or a retained interest in a securitization structure that commingles assets?

A—A transferor should treat the beneficial interests as new assets to the extent that the sources of the cash flows to be received by the transferor are assets transferred by another entity. Any
beneficial interests whose cash flows are derived from assets transferred by the transferor should be treated as retained interests. Any derivatives, guarantees, or other contracts entered into by the qualifying SPE to "transform" the transferred assets are considered to be new assets, not commingled assets, because they were entered into by the qualifying SPE rather than transferred into the qualifying SPE by another entity.

In the example provided, Transferor A would treat 50 percent of its beneficial interests as retained interests and 50 percent of its beneficial interests as new assets.

Paragraph 183 acknowledges that determining whether a beneficial interest in a securitization is a new asset or a retained interest is difficult. That paragraph explains:

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.

As part of its response to those issues, the Board decided to include in paragraph 33 the default provision that "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."

59. Q—EITF Topic No. D-75, "When to Recognize Gains and Losses on Assets Transferred to a Qualifying Special-Purpose Entity," addresses in certain circumstances when to recognize gains and losses on assets sold by qualifying SPEs under Statement 125. The scope of Topic D-75 is limited to situations in which the transferor retains 100 percent of the beneficial interests in the transferred assets. Should Topic D-75 be applied by analogy to transfers in which the transferor retains less than 100 percent of the beneficial interests in the transferred assets?

A—Yes. The concepts discussed in Topic D-75 apply to the proportion of the assets that were transferred in exchange for beneficial interests in transfers in which a transferor retains less than 100 percent of the beneficial interests in the transferred assets.

60. Q—The issue addressed in Topic D-75 is explained by the following example:

An entity transfers appreciated equity securities to a qualifying SPE that has a predetermined life in exchange for 100 percent of the beneficial interests in those transferred assets. That qualifying SPE is required to sell the transferred equity securities at a predetermined date and reinvest the proceeds in new debt securities that mature at the same date that the qualifying SPE liquidates.

Assume the facts in that example and the following additional facts:

• The beneficial interests are issued in the form of debt securities indexed to the transferred equity securities.
• Prior to the transfer, the equity securities were accounted for as available-for-sale securities in accordance with Statement 115.
Does the transferor have the option to classify the debt securities as trading at the time of the transfer?

A—Generally not. That response is based on the following:

- The Statement 115 securities held by the transferor after the transfer convey rights to the same cash flows as did the Statement 115 securities held before the transfer.
- Paragraph 15 of Statement 115 explains that transfers into or from the trading category should be rare.

In contrast, if the transferred assets were not Statement 115 securities prior to the transfer but the beneficial interests were issued in the form of debt securities or in the form of equity securities that have readily determinable fair values, then the transferor would have the opportunity to decide the appropriate classification at the date of the transfer.

61. Q—The third question in the illustrations of Topic D-75 addresses whether the transferor should recognize a gain when it transfers assets to a qualifying SPE that enters into a forward contract under the following circumstances:

   ... an entity transfers appreciated equity securities to a qualifying SPE in exchange for 100 percent of the beneficial interests in those transferred assets. Those beneficial interests entitle the holder to a fixed rate of interest for five years. On the fifth anniversary of the transfer, the equity securities will be sold and the beneficial interest holders will receive the net proceeds. At its inception, the qualifying SPE enters into a forward contract to lock in the unrealized appreciation in the equity securities that exists on the date that the equity securities are transferred to the qualifying SPE.

Under those circumstances, how should the transferor account for the beneficial interests in the transferred assets subject to the forward?

A—As described in paragraph 4, Statement 125 generally does not address subsequent measurement of assets and liabilities. Accordingly, other existing literature should be considered. In some cases, the accounting for the beneficial interests in the transferred assets subject to the forward contract would be accounted for under EITF Issue No. 96-12, "Recognition of Interest Income and Balance Sheet Classification of Structured Notes," until the transferor adopts Statement 133 Accounting for Derivative Instruments and Hedging Activities. Once the transferor adopts Statement 133, the entity would need to consider whether the beneficial interests contain embedded derivatives.

62. Q—In certain scenarios contemplated by Topic D-75, the appropriate guidance for accrual of interest on the beneficial interests is in Issue 96-12. In those cases, what is the initial investment amount for purposes of applying Issue 96-12?

A—The carrying amount of the assets at the date of transfer represents the initial investment for purposes of applying Issue 96-12. If the transferred assets were accounted for as available-for-sale by the transferor prior to the transfer, the application of Issue 96-12 should not result in recognition of an unrealized gain or loss before it is realized. The following example illustrates those concepts.

Assume the following facts and circumstances:

An entity transfers financial assets that are primarily appreciated equity securities to a qualifying SPE in exchange for 100 percent of the beneficial interests in the qualifying
SPE. (The original cost basis for the equity securities is $100, and the fair value is $150 at the date of transfer to the qualifying SPE. Because those securities are accounted for as available-for-sale securities under Statement 115, the carrying amount at the date of transfer is $150 and the unrealized gain in other comprehensive income is $50. The other transferred asset is a debt security, classified as trading prior to the transfer, which has a fair value of $20 on the date of transfer.) Those beneficial interests entitle the holder to a fixed rate of interest for five years. On the second anniversary of the transfer, the qualifying SPE is required to sell the equity securities and reinvest the proceeds in debt securities. (On the first and second anniversaries of the transfer, the equity securities had appreciated to $160 and $170, respectively. Also on the first anniversary of the transfer, the debt security is sold. The proceeds from that debt security are used to make the interest payments to the beneficial interest holders.) Upon the fifth anniversary of the qualifying SPE, the assets remaining in it will be sold and the beneficial interest holders will receive the proceeds.

For purposes of applying Issue 96-12, the initial investment in the beneficial interests that are structured notes is $170. The unrecognized gain of $50 would be recognized when realized (that is, when the equity securities are sold on the second anniversary of the qualifying SPE).

62A. Q—Assume an entity transfers a bond to a qualifying SPE for cash and beneficial interests. When the transferor purchased the bond, it paid a premium for it (or bought it at a discount) and that premium was not fully amortized (or accreted) at the date of the transfer. In other words, the carrying amount of the bond included a premium (or discount) at the date of the transfer. Would that previously existing premium (or discount) continue to be amortized?

A—Yes, but only to the extent a sale has not occurred because the transferor retained beneficial interests in the bond. Paragraph 10 requires that, upon completion of any transfer, a transferor (a) continue to carry in its statement of financial position any retained interest in the transferred assets and (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. That allocation process may change the amount of the premium (or discount) that is amortized thereafter as an adjustment of yield pursuant to FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.

63. Q—In a transfer of financial assets in which the transferor retains beneficial interests in 99 percent of the transferred assets, should the remaining 1 percent of transferred assets be treated as a sale assuming that all the criteria in paragraph 9 have been met?

A—Yes. Paragraph 9 specifies that "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" (emphasis added).

64. Q—Does the fair value measurement of a retained interest in a securitization that is classified as either available-for-sale or trading under Statement 115 include the estimated cash flows associated with the retained interests that are generated from receivables that do not yet exist but that will be originated and transferred during the revolving period (such as in securitizations with revolving features or prefunding provisions)?

A—No. Paragraph 52 explains that "gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold."

65. Q—Can the method used by the transferor for providing "recourse" affect the accounting for the
transfer?

A—Yes. However, before the method of recourse can be evaluated for the appropriate accounting treatment, the entity must first determine whether a sale has occurred because in some jurisdictions recourse might mean that the transferred assets have not been isolated beyond the reach of the transferor and its creditors.

A transferor may retain all or some portion of the credit risk associated with transferred financial assets. For example, a transferor may incur a liability to reimburse the transferee for a failure of debtors to pay when due (a recourse liability). In that case, a liability should be separately recognized and initially measured at fair value. That liability should be subsequently measured according to accounting pronouncements for measuring similar liabilities. In other cases, a transferor may provide similar credit enhancement by retaining a beneficial interest in the transferred assets that is paid to the transferor after other investors in the transferred assets are paid, thereby absorbing much of the related credit risk. If there is no liability beyond the transferor's retained subordinated interests, then the retained interests should be initially recognized according to paragraph 10 and should be subsequently measured like other retained interests held in the same form. Therefore, no recourse liability would be needed.

66. Q—What should the transferor consider when determining whether retained credit risk is a separate liability or part of a retained beneficial interest in the asset?

A—The transferor should focus on the source of cash flows in the event of a claim by the transferee. If the transferee can only "look to" cash flows from the underlying financial assets, the transferor has retained a portion of the credit risk through its retained interest and a separate obligation should not be recognized. Credit losses from the underlying assets would affect the measurement of the transferor's retained interest. In contrast, if the transferor could be obligated for more than the cash flows provided by its retained interest and, therefore, could be required to "write a check" to reimburse the transferee for credit-related losses on the underlying assets, the transferor would record a separate liability rather than an asset valuation allowance on the date of the transfer.

67. Q—What is meant by the term practicable as used in paragraphs 11(c) and 45?

A—The Board did not define the term practicable in Statement 125. However, the Board explained its reasoning for the practicability exception. Paragraph 209 states:

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 was asked to clarify the meaning of the term practicable, especially in relation to the use of the same term in Statement 107. The Board ultimately decided not to provide additional guidance about applying that term. Therefore, determining when it is not practicable to estimate the fair value of assets or liabilities requires judgment. In those circumstances, paragraph 45 establishes special requirements if it is not practicable to estimate the fair value of assets obtained or liabilities incurred. Paragraph 17(d) also requires that an entity provide a description of the items for which it was not practicable to estimate the fair value and the reasons why it was not practicable. However, in a vast majority of circumstances, it should be practicable to estimate fair values.

68. Q—At what value should the transferor initially recognize an asset obtained or a liability incurred

Superseded by the FASB Accounting Standards Codification on July 1, 2009.
for which, at the date of transfer, it was not practicable to estimate the fair value?

A—♦ Paragraph 45 states:

If it is not practicable to estimate the fair values of assets [at the time of transfer], the transferor shall record those assets at zero [emphasis added]. 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.

That is, Statement 125 requires that assets be recorded at fair value or at zero if it is not practicable to estimate the fair value of assets at the date of the transfer, not at some amount that is not a reliable estimate of fair value.

♦ Paragraph 210 notes that the practicability exception does not extend to the transferee, since as "... the purchaser of the assets, it [the transferee] should be able to value all assets and any liabilities it purchased or incurred, presumptively based on the purchase price paid."

69. Q—Statement 125 requires a fair-value-based measurement for a recourse obligation unless it is not practicable to measure its fair value. If it is not practicable for the transferor to measure the fair value of the recourse obligation, then the transferor should refer to ♦ paragraph 45, which provides a procedure for determining the appropriate measurement. That formula is based in part on what would be the appropriate measurement under Statement 5 and whether that amount is greater than the amount calculated in paragraph 45(a) of Statement 125. Assuming that the Statement 5 amount is greater than the amount calculated in paragraph 45(a) of Statement 125, how does an entity determine the amount to be accrued under Statement 5? [Revised 9/99.]

A—Determining the estimated amount of credit losses that should be accrued at the date of the transfer depends on whether all criteria for accrual of a loss contingency in Statement 5 have been met, not simply whether losses are probable. ♦ Paragraph 8 of Statement 5 explains:

An estimated loss from a loss contingency . . . shall be accrued by a charge to income if both of the following conditions are met:

a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b. The amount of loss can be reasonably estimated. [Footnote references omitted.]

To elaborate, under Statement 5, only losses that have been incurred would be recorded. In contrast, had it been practicable to estimate fair value, then the entity also would have considered future losses.

Interpretation 14 provides guidance if there is a range of probable loss amounts.
Paragraph 45 provides guidance on accounting for assets and liabilities in cases where, at the date of transfer, it is not practicable to estimate their fair values. However, if at a later date the transferor can estimate the fair value of an asset or liability for which it was not practicable at the date of the transfer (that is, it becomes practicable), should that asset or liability be remeasured?

A—If it becomes practicable for the transferor to estimate the fair value of the affected asset at a later date, the transferor would not remeasure the asset or the resulting gain or loss under Statement 125. However, if the affected asset is a servicing asset, Statement 125 requires that it be evaluated for impairment. In other cases, the transferor may be required to subsequently adjust that asset's carrying amount depending on the accounting pronouncement that addresses its subsequent measurement. One possible result is that an asset may be initially recognized at zero or a liability may be initially recognized at something other than fair value because of the practicability exception in Statement 125 and then subsequently measured at an estimate of fair value with changes in fair value recognized according to the requirements of the relevant pronouncement. For example, some assets may be required to be subsequently measured at fair value even if it is not practicable to estimate their fair value at the date of transfer (for example, Statement 115 does not provide a practicability exception). If it becomes practicable for the transferor to estimate the fair value of an affected liability at a later date, the transferor would remeasure that liability under Statement 125 only if it is a servicing liability.

The transferor would remeasure a servicing liability but not below the amortized measurement of its initially recognized amount. ♦ Paragraph 37(h) requires servicers to:

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, . . . the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings. . .

For other liabilities, other accounting pronouncements that address subsequent measurement may require that the transferor subsequently adjust an affected liability's carrying amount.

Must a transferor recognize in earnings the gain or loss that results from a transfer of financial assets that is accounted for as a sale, or may the transferor elect to defer recognizing the resulting gain or loss in certain circumstances?

A—♦ Paragraph 11(d) requires that upon the completion of a transfer of financial assets that satisfies the conditions to be accounted for as a sale, any resulting gain or loss must be recognized in earnings. It is not appropriate for the transferor to defer any portion of a resulting gain or loss (or to eliminate "gain on sale" accounting, as it is sometimes described in practice). As described previously in Question 68, ♦ paragraph 45 provides special requirements if it is not practicable to estimate the fair value of assets obtained or liabilities incurred.

Does Statement 125 require disclosures about the assumptions used to estimate fair values of retained interests in transferred financial assets or of assets obtained and liabilities incurred as proceeds in a transfer?

A—♦ Paragraph 17(d) requires that "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," an entity shall disclose "a description of those items and the reasons why it is not practicable to estimate their fair value." Paragraph 17(e) requires disclosure of "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" (emphasis added). Statement 125 does not specifically address disclosures about the assumptions used to estimate the fair value of assets other than servicing assets. However, the SEC staff made an announcement at the March 1998 EITF meeting on the disclosures that a registrant should provide in connection with estimating the fair value of retained and new interests that arise in a transfer of financial assets. Those disclosure requirements are addressed in EITF Topic No. D-69, "Gain Recognition on Transfers of Financial Assets under FASB Statement No. 125."

73. Q—A transferor transfers loans with a fair value of $100 to a qualifying SPE in exchange for cash of $100. However, to enhance the credit rating of the beneficial interests in the qualifying SPE, a cash reserve account is created in connection with the transfer. That cash reserve account is funded with $20 of the transferor's proceeds and $20 of additional cash contributed by the transferor. The cash will be returned to the transferor at some date in the future provided that a certain level of collections occurs but will be reduced to the extent that collections fall short of that level.

Are proceeds (in a transfer that is accounted for as a sale) that are placed in a cash reserve account (as a form of a credit enhancement) a new asset or a retained interest in transferred assets?

A—The proceeds that are placed in a cash reserve account are a retained interest. Paragraph 33 specifies that a cash reserve account is a retained interest. That answer also would apply if the seller collects the proceeds and then deposits a portion of those proceeds in the cash reserve account. Refer to Questions 74 and 75.

74. Q—How should a transferor initially and subsequently measure credit enhancements provided in a transfer if the balance that is not needed to make up for credit losses is ultimately to be paid by the transferor?

A—Credit enhancements such as cash reserve accounts and subordinated beneficial interests should 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. Credit enhancements provided by others such as financial guarantees and credit derivatives are new assets that are initially measured at the fair value of the portion of the enhancement expected to benefit the transferor.

Statement 125 does not specifically address the subsequent measurement of credit enhancements. Whether the transferor will receive cash inflows from the cash reserve account depends on the performance of the transferred assets. Entities should regularly review those assets for impairment because of their nature. Entities must look to other guidance for subsequent measurement including impairment 13(14) based on the form of the credit enhancement.

75. Q—In certain securitization transactions, the transferor must provide a credit enhancement such as a cash reserve account or a subordinated beneficial interest to complete the transaction. As discussed briefly in Question 73, a cash reserve account might work as follows. The transferor retains the majority of the credit risk associated with the transferred assets (for example, loans) by retaining a subordinated tranche (the Z tranche) of the beneficial interests. The transferor also may make a funding deposit into a cash reserve account. As loans are collected by the qualifying SPE, a specified portion of the cash flows attributable to the Z tranche are accumulated in the cash reserve account for possible distribution to the other beneficial interest holders if specified collection targets are not met. However, if those collection targets are met, distributions are to be made from the cash reserve account to the transferor as holder of the Z tranche beneficial interests.

How should an entity estimate the fair value of a credit enhancement such as a cash reserve account or subordinated beneficial interest provided by the transferor in a transfer (for purposes of
Paragraphs 42-44 provide guidance on how to estimate fair value under Statement 125. Transferors are required to estimate fair value in a manner consistent with those paragraphs. When estimating the fair value of a credit enhancement, the transferor's assumptions should include the period of time that its use of the asset is restricted, reinvestment income, and potential losses due to uncertainties. Those assumptions must be considered to satisfy the requirement in paragraph 43 to "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."

One valuation technique that might be acceptable is the "cash-out" method. Under the cash-out method, cash flows are discounted from the date the credit enhancement becomes available to the transferor (that is, when the cash in the credit enhancement account is expected to be paid out to the transferor, hence the term, cash out). Therefore, with an appropriate discount rate, the cash-out method estimates the fair value in a manner consistent with paragraph 43 (that is, both the entire period of time that the transferor's use of the asset is restricted and the potential losses due to uncertainties are considered when estimating the fair value of the credit enhancement).

In contrast, under most "cash-in" methods, the assumed discount period generally ends when the qualifying SPE is expected to collect the specified amount of loans (that is, when the cash is expected to come into the qualifying SPE, hence the term, cash in). In some cases, once the cash is "in the qualifying SPE," credit uncertainties arising subsequent to that date that are associated with the transferred assets are not always considered in the estimate of the fair value of the credit enhancement. As a result, the amount calculated under the cash-in method usually is closer to par value or face value than fair value. A method that (a) does not appropriately discount the credit enhancement asset for the entire period it is restricted under the credit enhancement agreement or (b) may not consider all of the credit uncertainties that the market would consider is not an appropriate method to estimate the fair value of credit enhancements such as cash reserve accounts and subordinated beneficial interests even though it might be possible for that estimated amount to approximate fair value in certain circumstances.

**Servicing Assets and Servicing Liabilities**

**Adequate Compensation**

76. Q— Paragraph 36 states that "typically, the benefits of servicing are expected to be more than adequate compensation to the servicer for performing the servicing . . . " (emphasis added). What is meant by the term adequate compensation?

A— Paragraph 243 defines adequate compensation as "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." Adequate compensation is the amount of contractually specified servicing fees and other benefits of servicing that are demanded by the marketplace to perform the specific type of servicing. Adequate compensation is determined by the marketplace; it does not vary according to the specific servicing costs of the servicer. Therefore, a servicing contract that entitles the servicer to receive benefits of servicing just equal to adequate compensation, regardless of the servicer's own servicing costs, does not result in recognizing a servicing asset or a servicing liability. A servicer should record an asset if the benefits of servicing exceed adequate compensation and a liability if the benefits of servicing are less than adequate compensation.

77. Q— If it is not practicable to determine adequate compensation, would it be acceptable to use the
servicer's cost plus a profit margin to estimate the fair value of a servicing asset or liability for which a quoted market price is not available?

A—No. If it is not practicable to determine adequate compensation and a quoted market price is not available, then it is not practicable to determine fair value. In those circumstances, a transferor should refer to ♦ paragraph 45 for guidance.

77A. Q—Does the response to Question 77 mean that an entity is precluded from using a cash flow model to estimate adequate compensation?

A—No. As explained in ♦ paragraph 45, if a quoted market price is not available, an entity should use a valuation technique such as a cash flow model to estimate the fair value of servicing unless it is not practicable to do so. Question 77 describes a situation in which the entity making the estimate has determined that it is not practicable to estimate adequate compensation using market assumptions. Adequate compensation is one of two amounts that must be determined to measure the fair value of servicing. Therefore, it is not practicable to estimate the fair value of servicing if an entity cannot estimate adequate compensation. Refer to Question 77.

78. Q—Assume that a transferor undertakes an obligation to service mortgage loans that it originated and subsequently sold. The transferor believes that the benefits of that servicing slightly exceed "adequate compensation" and, therefore, that a small servicing asset should be recorded. However, on the date of the sale, the servicer receives an unsolicited bid from a third-party servicer that is a major market participant to purchase the right to service for a much larger sum. After due diligence, the transferor determines that the bid is legitimate. Which amount, the transferor's earlier estimate of fair value or the amount of the bid, should be the basis for allocation of the previous carrying amount of the transferred mortgages between the servicing asset retained and the loans sold?

A—Statement 125 requires that an allocated portion of the previous carrying amount of the transferred mortgage loans be recorded as a servicing asset based on the relative fair value of the portion of the asset retained (the right to service) and the portion of the asset sold. The transferor should use the unsolicited bid from the third party as the basis for determining the relative fair value of servicing as it represents a quoted market price for its asset. ♦ Paragraph 42 indicates that "if a quoted market price is available, the fair value is the product of the number of trading units times market price" (emphasis added).

79. Q—Assume that a transferor undertakes an obligation to service loans that it originated and subsequently sold. In connection with that transaction, the transferor believes that the benefits of servicing exactly equal adequate compensation and, therefore, no servicing asset or liability should be recorded. To substantiate its assertion and because the market is shallow, the transferor contacts a broker and asks it to provide an estimate of the value of the transferor's servicing. The broker estimates that the transferor's servicing has substantial value (that is, the servicing should be recorded as a significant asset) but does not make or transmit a bid. What amount (zero or an allocated portion of the previous carrying amount of the transferred mortgages based on the amount of the estimate) should be recorded?

A—As discussed in Question 78, Statement 125 requires that an allocated portion of the previous carrying amount of the transferred mortgage be recorded as a servicing asset based on the relative fair value of the portion of the asset retained (the right to service) and the portion of the asset sold. This question highlights the potential for significantly different estimates of fair value of servicing when a quoted market price in an active market is not available. The difference between the two estimates suggests a need to perform more analysis to determine the best estimate of fair value.

♦ Paragraph 42 indicates that "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." However, an estimate of fair value (that is not a bid) from a single third party in an inactive or shallow market does not constitute a quoted market price even though it raises questions about the reasonableness of the transferor's estimated fair value of zero. The transferor should analyze all available facts and circumstances, including the information provided by the broker about its estimate of the value of the transferor's servicing asset, in determining its best estimate of the fair value of the servicing contract. Some factors to consider include:

- The objective for any estimate is to determine the fair value of the servicing asset or servicing liability, which 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" (paragraph 42).
- The legitimacy of the offer, the third party's specific knowledge about factors relevant to the fair value estimate, the experience of the broker in purchases of similar servicing contracts, and whether other parties have demonstrated interest in purchasing the servicing contract at a similar price.

79A. Q—Assume an entity estimates the fair value of a servicing asset or liability by estimating the benefits of servicing and adequate compensation and comparing those amounts, as described in paragraph 36. Based on that estimate, the entity believes the value of the servicing is X. However, the entity obtains a quoted market price of Y. Which amount should the transferor use as its fair value for the servicing asset (or liability)?

A—The quoted market price. ♦ Paragraphs 42-44 explain how to determine fair value under Statement 125. Paragraph 43 explains that an estimate of fair value shall be made only when a quoted market price is not available (refer to Questions 78 and 79). The fact that the estimate of fair value is not the same as the quoted market price suggests that the model used to make the estimate may be flawed or the assumptions may be inappropriate.

The goal when estimating the value of servicing is to determine fair value (that is, what the market would pay or charge to assume servicing). Therefore, when estimating the benefits of servicing, the benefits that should be included in the estimation model are those benefits that the market would consider, to the extent that the market would consider them. Similarly, when estimating adequate compensation, the estimated costs of servicing should be representative of those costs in the marketplace and should include a profit assumption equal to the profit demanded in the marketplace.

79B. Q—Assume that the quoted market price for servicing is lower than a transferor's estimate of fair value at the date of, and subsequent to, a transfer of assets in which the transferor retains those servicing rights. Can the transferor use the quoted market price to determine fair value when measuring the initial recognition amount and use its estimate of fair value when subsequently measuring impairment, if any?

A—No. ♦ Paragraphs 42-44 explain how to determine fair value under Statement 125. Paragraph 43 explains that an estimate of fair value shall be made only when a quoted market price is not available (refer to Questions 78 and 79). The fact that the estimate of fair value is not the same as the quoted market price suggests that the model used to make the estimate may be flawed or the assumptions may be inappropriate. That fact should be taken into account in subsequent estimates of fair value if quoted market prices are not available. Refer to Question 79A.

80. Q—To what extent should benefits other than contractually specified fees, such as late charges and other ancillary revenue, be considered when valuing servicing assets and servicing liabilities?
A—Paragraph 243 defines benefits of servicing as "revenues from contractually specified servicing fees, late charges, and other ancillary sources, including 'float.'" The extent to which late charges and other ancillary revenue should be considered when determining the fair value of servicing should be consistent with the emphasis that the marketplace would place on such benefits when acquiring the obligation to service the underlying assets.

81. Q—When estimating the fair value of servicing assets and liabilities, with regard to the benefits of servicing that are dependent on future transactions such as collecting late charges, should an entity estimate the value of the right to benefit from those potential transactions? Alternatively, should an entity estimate the value of the expected cash flows to be derived from those future transactions?

A—The entity should estimate the value of the right to benefit from the cash flows of potential future transactions, not the value of the expected cash flows to be derived from future transactions.

When estimating the fair value of servicing assets and liabilities, the goal is to estimate the "amount at which that asset (or liability) could be bought (or incurred), or sold (or settled) in a current transaction between willing parties . . ." (§ paragraph 42). A potential servicer might be willing to pay more for servicing if the benefits of that servicing included the right to collect late charges than it would pay if the benefits of servicing did not include those rights.

82. Q—For sales of mortgage loans, is adequate compensation the same as normal servicing fees previously used in applying Statement 65?

A—No. Paragraph 243 of Statement 125 defines adequate compensation as "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."

Prior to being amended by Statement 125, Statement 65 defined the term current (normal) servicing fee rate (normal servicing 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." Therefore, under Statement 65, normal servicing rates were based on the amounts most commonly charged for servicing a specific type of mortgage loan. The normal servicing rate was not used in estimating the aggregate initial carrying amount of servicing assets under the provisions of Statement 65, as amended by FASB Statement No. 122, Accounting for Mortgage Servicing Rights. Instead, it ensured that the amounts attributed to normal servicing activities were consistent among servicers of similar assets by designating contractually specified servicing rates above normal as excess servicing.

Often, a normal servicing rate, as that term was previously applied in practice under Statement 65, would result in more than adequate compensation, as that term is used in Statement 125. As a result, a purchaser often would be required to compensate a seller to obtain the right to service loans for a normal servicing rate. In contrast, a purchaser would neither pay nor receive payment to obtain the right to service for a rate just equal to adequate compensation.

83. Q—Do the types of assets being serviced affect the amount required to adequately compensate the servicer?

A—Yes. Several variables, including the nature of the underlying assets, should be considered in determining whether a servicer is adequately compensated. For example, the amount of effort required to service a home equity loan likely would be different from the amount of effort required to service a credit card receivable or a small business administration loan. Therefore, entities should consider the nature of the assets being serviced as a factor in determining the fair value of a
servicing asset or liability.

84. **Q**—Does a contractual provision that specifies the amount of servicing fees that would be paid to a replacement servicer affect the determination of adequate compensation?

**A**—No. The amount that would be paid to the replacement servicer under the terms of the servicing contract can be more or less than adequate compensation. The determination of whether the servicer is adequately compensated for servicing specified assets is based on the amount demanded by the marketplace, not the contractual amount to be paid to a replacement servicer. However, that contractual provision would be relevant for determining the amount of contractually specified servicing fees, which are defined in paragraph 243 as:

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.

85. **Q**—If market rates for servicing a specific type of asset change subsequent to the initial recognition of a servicing asset or liability, does Statement 125 include any requirement to adjust the recorded asset or liability?

**A**—Yes, in certain circumstances. Paragraph 37 addresses the subsequent measurement of servicing assets and liabilities. Under paragraph 37, after a servicing asset is recognized, it should be evaluated for impairment at each balance sheet date. Paragraph 37 also requires that if subsequent events increase the fair value of a servicing liability, that increase must be recognized in earnings as a loss.

86. **Q**—Do additional transfers under revolving-period securitizations (for example, home equity loans or credit card receivables) result in the recognition of additional servicing assets or liabilities?

**A**—Yes. Paragraph 52 states that "as new receivables are sold, rights to service them become assets or liabilities and are recognized."

**Contractually Specified Servicing Fees**

87. **Q**—Paragraph 13 states that "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 [Statement 115]." In the latter circumstances, may an entity choose to recognize a servicing asset or liability?

**A**—Yes. Paragraphs 35 and 36 explain that (a) servicing is inherent in all financial assets and becomes a distinct asset or liability only when contractually separated from the underlying assets and (b) if the transferor securitizes the assets, retains all of the resulting securities, and classifies them as held-to-maturity debt securities, the servicing asset or liability may be reported together with the asset being serviced. That is, in those circumstances, the entity may choose to recognize the resulting servicing asset or liability separately from the asset being serviced or to aggregate the servicing asset or liability with the assets being serviced.

88. **Q**—How should an entity account for rights to future income from serviced assets that exceed
Paragraph 37 requires a servicing asset, an interest-only strip, or both to be recorded by a servicer if the benefits of servicing are expected to exceed adequate compensation for performing the servicing. It also states that a servicer should account for rights to receive future interest income from serviced assets that exceed contractually specified servicing fees separately from servicing assets. Those rights are not servicing assets; they are financial assets, effectively interest-only strips, that should be accounted for in accordance with paragraph 14.

Whether a right to future interest income should be accounted for as an interest-only strip, a servicing asset, or a combination thereof, depends on whether a servicer would continue to receive that amount (that is, the value of the right to future interest income) if a substitute servicer began servicing the assets. Paragraph 198 states that "... interest-only strips retained in securitizations ... do not depend on the servicing work being performed satisfactorily, [and] are subsequently measured differently from servicing assets that arise from the same securitizations." Therefore, any portion of the right to future interest income from the serviced assets that would continue to be received even if the servicing were shifted to another servicer would be reported separately as a financial asset in accordance with paragraph 14.

Q—Should a loss be recognized if a servicing fee that is equal to or greater than adequate compensation is to be received but the servicer's anticipated cost of servicing would exceed the fee?

A—No. Whether a servicing asset or liability is recorded is a function of the marketplace, not the servicer's cost of servicing. Paragraph 36 explains:

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.

Paragraph 243 defines adequate compensation as "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." The guidance in those two paragraphs does not consider the servicer's cost of servicing. Furthermore, the impairment provisions of paragraph 37(g) are based on the fair value of the contract rather than the gain or loss from subsequently carrying out the terms of the contract; future losses may be avoided by selling the servicing to a more efficient servicer. Statement 125 supersedes paragraph 11 and footnote 4 of Statement 65, which were based on a "loss contract" accounting approach instead of the market-based approach required by Statement 125.

Q—Should an entity recognize a servicing liability if it transfers all or some of a financial asset (for example, a loan participation) and retains an obligation to service the asset but is not entitled to receive a contractually specified servicing fee? Is the answer to this question affected by circumstances in which it is not customary for the transferor-servicer to receive a contractually specified servicing fee?

A—The transferor-servicer would be required to recognize a servicing liability at fair value if the benefits of servicing are less than adequate compensation. Paragraph 13 states that "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. . . ." That requirement applies even if it is not customary to charge a contractually specified servicing fee. ♦ Paragraph 36 states that "... if the benefits of servicing are not expected to adequately compensate the servicer for performing the servicing, the contract results in a servicing liability."

91. Q—Assuming that (a) an entity transfers a portion of a loan under a participation agreement that qualifies for sale accounting under Statement 125, (b) the selling entity obtains the right to receive benefits of servicing that more than adequately compensate it for servicing the loan, and (c) the selling entity would continue to service the loan, regardless of the transfer because it retains part of the participated loan, is the selling entity required to record a servicing asset?

A—Yes. The selling entity would be required to record a servicing asset for the portion of the loans it sold. ♦ Paragraph 35 states that while "servicing is inherent in all financial assets; it becomes a distinct asset or liability . . . when contractually separated from the underlying assets by sale. . . ." The assumption that the selling entity would service the loan because it retains part of the participated loan does not impact the requirement to recognize a servicing asset. Conversely, a selling entity could not avoid recording a servicing liability if the benefits of servicing are not expected to adequately compensate the servicer for performing the servicing.

92. Q—An entity sells mortgage loans that it has originated and retains the right to service them. Immediately thereafter, the entity enters into an arrangement to subcontract the obligation to service with another servicer. How should the entity account for the obligation to service as a result of those transactions?

A—The entity should account for the two transactions separately. First, the entity should account for the transfer of mortgage loans in accordance with Statement 125—the obligation to service should be accounted for according to ♦ paragraphs 10 and 11 as a retained interest (if it is a servicing asset) or as a liability incurred as a result of the transfer (if it is a servicing liability). Second, the entity should account for the subcontract with another servicer. The latter transaction is not within the scope of Statement 125 because it does not involve a transfer of the underlying mortgage loans and, therefore, should be accounted for under other existing guidance.

93. Q—When servicing assets are assumed without cash payment, what is the appropriate offsetting entry by the transferee?

A—The answer depends on whether an exchange or capital transaction has occurred.

If an exchange has occurred, then the transaction should be recorded based on the facts and circumstances. For example, the servicing asset may represent consideration for goods or services provided by the transferee to the transferor of the servicing. In that case, the offsetting entry by the transferee would be the same as if cash was received in exchange for the goods and services (that is, revenue or a liability as appropriate). 15(16) The servicing assets also might be received in full or partial satisfaction of a receivable from the transferor of the servicing. In those cases, the offsetting entry by the transferee would be to derecognize all or part of the receivable satisfied in the exchange.

Another possibility is that an investor is in substance making a capital contribution to the investee (the party receiving the servicing [that is, the transferee]) in exchange for an increased ownership interest. In that case, the investee should recognize an increase in equity from a contribution by owner.

It is difficult to envision scenarios in which a servicing asset would be assumed without cash payment or other consideration in an exchange or a capital transaction. In those scenarios, it is possible that the value of the servicing has been overstated by the transferee. Therefore, those
scenarios should be carefully scrutinized for changes in terms, restrictions on sale, and so forth, that may indicate that the value of the servicing has been overstated.

Q—Statement 125 requires that an entity separately evaluate and measure impairment of designated strata of servicing assets. Must servicing assets be stratified based on more than one predominant risk characteristic of the underlying financial assets if more than one characteristic exists?

A—No. Paragraph 37(g)(1) requires servicers to "stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets" (emphasis added). Therefore, Statement 125 does not require that either the most predominant risk characteristic or more than one predominant risk characteristic be used to stratify the servicing assets for purposes of evaluating and measuring impairment. A servicer must exercise judgment when determining how to stratify servicing assets (that is, when selecting the most appropriate characteristic(s) for stratification). The approach in Statement 125 for the stratification of servicing assets for purposes of evaluating and measuring impairment is consistent with the approach required by Statement 65, as amended by Statement 122.

Pursuant to paragraph 56 of Statement 133, "at the date of initial application, mortgage bankers and other servicers of financial assets may choose [but are not required] to reclassify their servicing rights pursuant to paragraph 37(g) of Statement 125 in a manner that would enable individual strata to comply with the requirements of this Statement regarding what constitutes 'a portfolio of similar assets.'" An entity may use different stratification criteria for the purposes of Statement 125 impairment testing and for the purposes of grouping similar assets to be designated as a hedged portfolio in a fair value hedge under Statement 133.

Q—Paragraph 37(g)(1) requires a servicer to "stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets." Should the strata selected by the servicer be used consistently from period to period?

A—Generally, yes. Once an entity has determined the predominant risk characteristics to be used in identifying the resulting strata of servicing assets, that decision should be applied consistently unless significant changes in economic facts and circumstances clearly indicate that the predominant risk characteristics and resulting strata should be changed. If a significant change in economic facts and circumstances occurs, that change should be accounted for prospectively as a change in accounting estimate in accordance with paragraphs 31-33 of APB Opinion No. 20, Accounting Changes. If the predominant risk characteristics and resulting strata are changed, that fact and the reasons for those changes should be included in the disclosures about the risk characteristics of the underlying financial assets used to stratify the recognized servicing assets in accordance with paragraph 17(e)(3) of Statement 125.

Q—Similar to Statement 125, Statement 122 required that entities separately evaluate and measure impairment of designated strata of servicing assets. Although Statement 122 amended Statement 65, an entity was not required to designate servicing assets that were recognized under Statement 65 prior to the effective date of Statement 122 in strata for purposes of evaluating and measuring impairment (that is, Statement 122 "grandfathered" the stratification of servicing assets that were previously recognized under Statement 65). Did Statement 125 also "grandfather" the requirement to stratify servicing assets previously recognized under Statement 65?

A—No. Statement 125 requires an entity to evaluate and measure impairment according to the provisions of paragraph 37(g) for all servicing assets that it continues to recognize after December 31, 1996.

Q—Statement 125 requires impairment of servicing assets to be recognized "through a valuation
allowance for an individual stratum" (paragraph 37(g)(2), emphasis added). The valuation allowance should "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" (paragraph 37(g)(3)). How should an entity recognize subsequent increases in a previously recognized servicing liability?

A—Statement 125 states that "... 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 37(h)). Similar to the accounting for changes in a valuation allowance for an impaired asset, increases in the servicing obligation may be recovered, but the obligation should not be reduced below the amortized measurement of the initially recognized servicing liability.

98. Q—Assume that a transferor transfers financial assets and undertakes an obligation to service those financial assets. If it is not practicable for a transferor to measure the fair value of servicing at the date of transfer, is the transferor required to evaluate whether its obligations under the servicing agreement represent a liability?

A—Yes. When applying paragraph 45, the transferor must evaluate whether a liability has been incurred as a result of its obligations under the servicing agreement and should not automatically assume that an asset exists (that is, not automatically assume that the answer is zero).

99. Q—Should a valuation technique using undiscounted cash flows ever be used to estimate fair value of servicing liabilities? Or should a valuation technique based on future cash flows always include a discounting element?

A—A valuation technique that includes a discounting element should be used to estimate fair value. Using a valuation technique that does not consider the time value of money (discounting element) would be inconsistent with the notion of fair value as described in paragraphs 42-44. Further, paragraph 43 explains that when measuring "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."

Financial Assets Subject to Prepayment

100. Q—If an entity recognizes both a servicing asset and the right to receive future interest income from serviced assets in excess of contractually specified servicing fees (an interest-only strip), should the value of the right to receive future cash flows from ancillary sources such as late fees be included in measuring the servicing asset or the interest-only strip?

A—Generally, in the servicing asset. The value of the right to receive future cash flows from ancillary sources such as late fees is included in the measurement of the servicing asset, not the interest-only strip, if retention of the right to receive the cash flows from those fees depends on servicing being performed satisfactorily, as is generally the case. As discussed in paragraph 198, an interest-only strip does not depend on servicing being performed satisfactorily.

101. Q—Paragraph 14 requires that interest-only strips and similar financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment subsequently be measured like investments in debt securities classified as available-for-sale or trading under Statement 115. Does that requirement result in those financial assets being included in the scope of Statement 115?
A—Whether those financial assets are included in the scope of Statement 115 depends on the form of the assets. However, in either case, the measurement principles of Statement 115, including the provisions for recognizing and measuring impairment, should be applied.

Interest-only strips and similar retained interests meeting the definition of securities in paragraph 137 of Statement 115 are included in the scope of Statement 115; therefore, all relevant provisions of that Statement (for example, the disclosures) should be applied. Those interests should be classified as available-for-sale or trading pursuant to the provisions of paragraph 7 of Statement 115, as amended by paragraph 233 of Statement 125.

Interest-only strips and similar retained interests that are not in the form of securities (as defined in Statement 115) are not within the scope of Statement 115 but should be measured like investments in debt securities classified as available-for-sale or trading. In that case, all of the measurement provisions, including those addressing recognition and measurement of impairment, should be followed. However, other provisions of Statement 115, such as those addressing disclosures, are not required to be applied.

Upon adoption of Statement 133, the transition provisions in paragraph 55 of Statement 133 may be applied to financial assets that are within the scope of paragraph 14 of Statement 125, thereby enabling an entity to reclassify any such assets previously measured like an available-for-sale debt security into the trading category. Further discussion is provided in Statement 133 Implementation Issue No. J7, "Transition Provisions: Transfer of Financial Assets Accounted for Like Available-for-Sale Securities into Trading." [Revised 9/99.

102. Q—Can a financial asset that can be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment be classified as held-to-maturity if the investor concludes that prepayment or other forms of settlement are remote?

A—No. The probability of prepayment or other form of settlement that would result in the holder's not recovering substantially all of its recorded investment is not relevant in deciding whether the provisions of paragraph 14 apply to those assets.

103. Q—A transferor transfers mortgage loans to a third party but retains servicing. Subsequent to the transfer, the transferor enters into a subservicing arrangement with a third party. If the transferor's benefits of servicing exceed its obligation under the subservicing agreement, should that differential be accounted for as an interest-only strip?

A—No. The entity should account for the two transactions separately. First, the entity should account for the transfer of mortgage loans in accordance with Statement 125—the obligation to service should be accounted for according to paragraphs 10 and 11 as a retained interest (if it is a servicing asset) or as a liability incurred as a result of the transfer (if it is a servicing liability). Second, the entity should account for the contract with the subservicer. The latter transaction is not within the scope of Statement 125 because it does not involve a transfer of the underlying mortgage loans and, therefore, should be accounted for under other existing guidance. Refer to Question 92.

104. Q—Can a debt security that is purchased late enough in its life such that, even if it was prepaid, the holder would recover substantially all of its recorded investment, be initially classified as held-to-maturity?

A—Yes. The debt security could be initially classified as held-to-maturity if the conditions of paragraph 7 of Statement 115 are met. Paragraph 7 allows that classification "only if the reporting
Paragraph 233 of Statement 125 added the following requirement to the end of paragraph 7 of Statement 115: "A [debt] 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 [debt] security would not recover substantially all of its recorded investment."

105. Q—May a loan (that is not a debt security) that when initially acquired or retained could be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment be reclassified as held for investment later in its life (that is, at a date that is so close to the asset's maturity that the holder would recover substantially all of its recorded investment even if it was prepaid)? In other words, would that loan no longer be required to be measured in accordance with the guidance in paragraph 14 of Statement 125?

A—Yes, if (a) it would no longer be possible for the holder not to recover substantially all of its recorded investment upon contractual prepayment or settlement and (b) the conditions for amortized cost accounting are met (for example, paragraph 6 of Statement 65 and paragraph 6.45 of the 1998 AICPA Guide on banks and savings institutions). However, any unrealized holding gain or loss arising under the available-for-sale classification that exists at the date of the reclassification would continue to be reported in other comprehensive income but should be amortized over the remaining life of the loan as an adjustment of yield. (The loan would not be classified as held-to-maturity because under Statement 115 and its interpretations, only debt securities may be classified as held-to-maturity.)

106. Q—Paragraph 14 requires that certain financial assets that are not in the form of debt securities be measured at fair value like investments in debt securities classified as available-for-sale or trading under Statement 115. How should instruments subject to the provisions of paragraph 14 be evaluated for impairment?

A—All of the measurement provisions of Statement 115, including recognition and measurement of impairment, should be applied to those financial assets. Further, other existing literature that interprets Statement 115 should be applied, as appropriate, to financial assets within the scope of paragraph 14. For example, EITF Issue No. 93-18, "Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate," provides guidance on how to apply the impairment provisions of Statement 115 to financial assets that are within the scope of EITF Issue No. 89-4, "Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate." Financial assets that are within the scope of Issue 89-4 generally are within the scope of paragraph 14 (that is, Issue 89-4 assets are a subset of paragraph 14 assets).

107. Q—Should the guidance in Issue 93-18 be applied by analogy to available-for-sale assets, for example, interest-only strips on commercial loans, that are within the scope of paragraph 14 but are not within the scope of Issue 89-4?

A—Yes, as long as application of Issue 93-18 does not defer the recognition of an impairment when an other-than-temporary impairment, as defined in Statement 115, has occurred. For example, an other-than-temporary impairment may have occurred even though the present value of future estimated cash flows, discounted at an appropriate risk-free rate, is greater than the carrying amount of the assets. In those cases, an impairment should be recognized when it is determined that the decline in fair value below the carrying amount of the assets is other-than-temporary in accordance with Statement 115.

108. Q—Is a financial asset that is not a debt security under Statement 115 subject to the requirements...
of paragraph 14 because it is denominated in a foreign currency?

A—No. An entity is not required to measure such an investment like a debt security under paragraph 14 unless it has provisions that allow it to be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, as denominated in the foreign currency. For example, an investment denominated in deutsche marks by an entity with a U.S. dollar functional currency would not be subject to paragraph 14 if the contract requires that substantially all of the invested deutsche marks be repaid. Investing in a financial asset that is denominated in a foreign currency often exposes an entity to foreign currency exchange rate risk; however, that risk is not addressed in paragraph 14. Paragraph 206 explains that "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."

108A. Q—Is a note for which the repayment amount is indexed to the creditworthiness of a party other than the issuer subject to the provisions of paragraph 14 (which precludes held-to-maturity classification)?

A—Yes. A note for which the repayment amount is indexed to the creditworthiness of a party other than the issuer is subject to the provisions of paragraph 14 because the event that might cause the holder to receive less than substantially all of its recorded investment is based on a contractual provision, not on a default by the borrower (that is, the issuer of the note). That contractual provision indexes the payment terms of the note to a default by a third party unrelated to the issuer of the note.

Once the holder of the note adopts Statement 133, it would need to assess whether the note is within the scope of Statement 133. If that note is within the scope of Statement 133, the guidance of paragraph 14 would no longer apply because Statement 133 amended paragraph 14 to exclude instruments subject to the provisions of Statement 133. Under Statement 133, the accounting likely will be different from the accounting under paragraph 14 of Statement 125.

108B. Q—Can a residual tranche debt security in a securitization of financial assets (for example, receivables) using a qualifying SPE be classified as held-to-maturity?

A—The answer depends on the facts and circumstances. If the contractual provisions of the residual tranche debt security provide that the residual tranche can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, the residual tranche debt security should not be accounted for as held-to-maturity in accordance with paragraph 14. In contrast, if the only way that the holder of the residual tranche would not recover substantially all of its recorded investment would be in response to a default by the borrower (debtor), then a held-to-maturity classification is acceptable as long as the conditions specified for a held-to-maturity classification in paragraph 7 of Statement 115, as amended, have been met. In that case, the borrower is the issuer of the receivables held by the qualifying SPE after the transfer has occurred.

Paragraph 127 explains that "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." Paragraph 184 elaborates on that effect by explaining that a transfer of assets to a qualifying SPE in a securitization changes the nature of the asset held by the transferor. Specifically that paragraph states that "retained interests in the transferred assets continue to be assets of the transferor, albeit assets of a different kind . . ." (emphasis added).

Paragraph 206 states 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” (emphasis added).

108C. Q— Paragraph 14 states that "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 . . ." (emphasis added). Does paragraph 14 apply only to other receivables that arise in securitizations that are subject to prepayment or, alternatively, does it apply to any other receivables that are subject to prepayment?

A—Paragraph 14 applies to any other receivables that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment. That is, the words in securitizations only apply to retained interests in the clause "interest-only strips, loans, other receivables, or retained interests in securitizations.”

Secured Borrowings and Collateral

109. Q—Are the collateral recognition requirements of paragraph 15 limited to transfers by or to broker-dealer entities, or do they apply to other types of borrowings, such as the origination of corporate debt and standard bank loans?

A—The collateral recognition provisions of paragraph 15 apply to the accounting for all transfers of financial assets pledged as collateral accounted for as a secured borrowing. Accordingly, they apply to repurchase agreement, dollar-roll, securities lending, and similar transactions, as well as to many other transactions. However, paragraph 15 does not apply to the accounting for the cash in borrowed secured transactions.

109A. Q—Assume a secured party, in a repurchase agreement accounted for as a secured borrowing, has taken control of the collateral pledged and, accordingly, recognizes the collateral as its own asset and an obligation to return the collateral. Could a secured party involved in a repurchase agreement apply the guidance in FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts, or No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements, to net the receivable established under the repurchase agreement with the obligation to return the collateral pledged?

A—No. Paragraph 5(c) of Interpretation 39 requires that the reporting party intend to settle. If the reporting party has the intent to settle the contract net (that is, the secured party will keep the collateral as satisfaction of its receivable under the repurchase agreement), then the debtor does not have an obligation to redeem the security. Thus, sale accounting would not be precluded under paragraph 9(c)(1).

If the "debtor" accounts for the transfer of collateral as a sale, the "secured party" would account for the transfer as a purchase of a security, not as receipt of a security subject to a sale agreement under paragraph 15. That reasoning is analogous to the rationale for why a repo-to-maturity transaction would be accounted for as a sale as explained in paragraph 147 of Statement 125.

Interpretation 41 does not apply because its scope is limited to offsetting of amounts related to certain repurchase and reverse repurchase agreements.
This answer also is applicable to non-repurchase agreement arrangements in which a transfer is accounted for as a secured borrowing and the secured party is required to recognize the collateral.

**110. Q**—What is the proper classification by the transferor of securities loaned or transferred under a repurchase agreement accounted for as a secured borrowing if (a) the transferee is permitted to sell or repledge those securities and (b) rights of substitution or termination are not granted to the transferor?

**A**—Paragraph 15 provides guidance on collateral recognition issues. Paragraph 15(a)(i) indicates that pledged assets should be reported in the statement of financial position separately from other assets not so encumbered. However, it does not specify the classification or the terminology to be used to describe those assets. Paragraph 65 illustrates possible classifications and terminology.

**111. Q**—What is the appropriate classification of liabilities incurred in connection with securities borrowing and resale agreement transactions?

**A**—Statement 125 does not specify classification or terminology to be used to describe liabilities incurred by either the secured party or debtor in securities borrowing or resale transactions. However, those liabilities should be separately classified. Paragraph 65 illustrates possible classifications and terminology.

**112. Q**—How should a transferor measure transferred collateral that must be reclassified (for example, as securities loaned to broker)?

**A**—Paragraph 15(a) requires transferred collateral that has been recognized by the transferee to be reclassified and reported separately by the transferor. That paragraph, however, does not change the transferor's measurement of that collateral. Because the transferor continues to control the collateral, it should not derecognize the collateral and should follow the same measurement principles as before the transfer. For example, securities reclassified from the available-for-sale category to securities loaned to broker should continue to be measured at fair value, with changes in fair value reported in comprehensive income, while debt securities reclassified from the held-to-maturity category to securities loaned to broker should continue to be measured at amortized cost.

**113. Q**—Does Statement 125 provide guidance on subsequent measurement of a secured party's (transferee's) obligation to return transferred collateral that it recognized in accordance with paragraph 15?

**A**—No. Statement 125 generally does not address subsequent measurement of transferred financial assets or the obligation to return transferred collateral. The liability to return the collateral should be measured in accordance with other relevant accounting pronouncements. For example, a bank or savings institution that, as transferee, sells transferred collateral is required to subsequently measure that liability like a short sale at fair value. Paragraph 5.92 of the 1998 AICPA Guide on banks and savings institutions states that "the obligations incurred in short sales should be reported as liabilities and adjusted to fair value through the income statement at each reporting date."

**Extinguishments of Liabilities**

**114. Q**—Are liabilities extinguished by legal defeasances?

**A**—Yes, if the condition in paragraph 16(b) is satisfied. In a legal defeasance, generally the
creditor legally releases the debtor from being the primary obligor under the liability. Whether the debtor has in fact been released and the condition in paragraph 16(b) has been met is a matter of law. Conversely, in an in-substance defeasance, the debtor is not released from the debt by putting assets in the trust—for that reason, and others identified in paragraph 220, an in-substance defeasance is different from a legal defeasance and the liability is not extinguished. A related issue is discussed in Question 33.

115. **Q**—How should a debtor account for the exchange of an outstanding debt instrument with a lender for a new debt instrument with the same lender but with substantially different terms? Other than as an exchange transaction, how should the debtor account for a substantial modification of a debt instrument?

**A**—Paragraph 16 permits derecognition of liabilities if and only if it is extinguished by one of the following conditions: the debtor pays the creditor and is relieved of its obligation or the debtor is legally released as the primary obligor, either judicially or by the creditor. The EITF addressed how a debtor should account for a substantial modification of a debt instrument in Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments."

116. **Q**—If an entity is released from being primary obligor and becomes a secondary obligor, should the entity recognize the resulting guarantee (from being the secondary obligor) in the same manner as a third-party guarantor?

**A**—Yes. As stated in paragraph 84, the entity should recognize the guarantee "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."

**Other**

117. **Q**—Does Statement 125 address impairment of financial assets?

**A**—As discussed in paragraph 4, Statement 125 "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." Accordingly, impairment of financial assets should be measured by reference to other applicable existing guidance, such as:

- Statement 5
- FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan (as amended by FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures)
- Statement 115
- Related EITF Issues.

118. **Q**—Many securitization structures provide for a disproportionate distribution of cash flows to various classes of investors during the amortization period, which is referred to as a turbo provision. For example, a turbo provision might require the first $100 million of cash received during the amortization period of the securitization structure to be paid to one class of investors before any cash is available for repayment to other investors. Similarly, certain revolving-period securitizations use what is referred to as a bullet provision as a method of distributing cash to their
investors. Under a bullet provision, during a specified period preceding liquidating distributions to investors, cash proceeds from the underlying assets are reinvested in short-term investments other than the underlying revolving-period receivables. Those investments mature or are otherwiseliquidated to make a single bullet payment to certain classes of investors.

What effect do such turbo and bullet provisions in securitization structures have on the accounting for the transfers of financial assets under Statement 125?

A—Under Statement 125, trust liquidation methods that allocate receipts of principal or interest between beneficial interest holders and transferors in proportions different from their stated percentage of ownership interests do not affect whether the transferor should obtain sale accounting and derecognize those transferred assets. Both turbo and bullet provisions should be taken into consideration, however, in determining the relative fair values of the portion of transferred assets sold and portions retained by the transferor.

119. Q—Has Statement 125 been amended since its issuance?

A—Yes. Statement 133, paragraph 536, amended Statement 125. That paragraph states:

FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, is amended as follows:

a. In paragraph 4, and that are not within the scope of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities is added to the end of the second sentence.

b. In paragraph 14, Except for instruments that are within the scope of Statement 133 is added to the beginning of the first sentence.

c. In the fourth sentence of paragraph 31, derivative financial instrument is replaced by derivative instrument.

d. In paragraph 243, the glossary, the definition of derivative financial instrument is replaced by:

   Derivative Instrument
   Refer to paragraphs 6-9 in FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities.

In addition, paragraph 5 of FASB Statement No. 127, Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125, delayed the effective date of certain provisions of Statement 125. That paragraph states:

Paragraph 19 of Statement 125 is replaced by the following:

This Statement shall be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996, except that:

a. Paragraph 15 shall be effective for all transfers of financial assets occurring after December 31, 1997.

b. For repurchase agreement, dollar-roll, securities lending, and similar transactions, paragraphs 9-12 and 237(b) shall be effective for transfers of financial assets occurring after December 31, 1997.
If it is not possible to determine whether a transfer occurring during calendar-year 1997 is covered by paragraph 19(b), then paragraphs 9-12 and 237(b) shall be applied to that transfer. All provisions of this Statement shall be applied prospectively, and earlier or retroactive application is not permitted.

120. Q—This Special Report identifies other guidance, for example, in the form of consensuses reached by the EITF, that interprets the guidance found in Statement 125. Does additional interpretative guidance exist and is more guidance planned?

A—Yes. For example, at its May 1998 meeting, the EITF reached a consensus on ♦ Issue 98-7 and ♦ Issue 98-8. Refer to Question 11. At its July 1998 meeting, the EITF added to its consensus on ♦ Issue 96-19. At the September 1998 EITF meeting, the FASB staff made an announcement (♦ Topic D-75) on when to recognize gains and losses on assets transferred to a qualifying SPE solely in exchange for beneficial interests in those assets. At its March 1999 meeting, the EITF reached a consensus on ♦ Issue No. 98-14, "Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements."
Endnotes

1 (Popup - Footnote *)
Q&A 125 Footnote *—At the date of issuance of this implementation guide, Jackson M. Day was a practice fellow at the FASB and Victoria A. Lusniak was an assistant project manager at the FASB. The positions and opinions expressed in this implementation guide were theirs. Revisions to this implementation guide have been made by current members of the FASB staff. Official positions of the FASB are determined only after extensive due process and deliberation.

2 (Popup - Footnote 1)
Q&A 125 Footnote 1—Whether or not that settlement is an extinguishment is governed by paragraph 16 of Statement 125.

3 (Popup - Footnote 2)
Q&A 125 Footnote 2—EITF Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions," and EITF Topic No. D-14, "Transactions involving Special-Purpose Entities," should be applied, as appropriate, to determine whether such a special-purpose entity should be consolidated by a nontransferor.

4 (Popup - Footnote 3)
Q&A 125 Footnote 3—SEC registrants should refer to SEC Staff Accounting Bulletin Topic 5-Z, "Accounting and Disclosure Regarding Discontinued Operations," Question 7, for guidance on the notion of temporary control. That question explains that the SEC staff believes the temporary control exemption under FASB Statement No. 94, Consolidation of All Majority-Owned Subsidiaries, "is applicable only if control is likely to be lost in the near term as a result of the probable occurrence of events that lie outside of the Company's control" (footnote reference omitted). Topic 5-Z also explains that the notion of temporary control does not encompass situations involving planned disposition of consolidated subsidiaries.

5 (Popup - Footnote 4)
Q&A 125 Footnote 4—For purposes of applying paragraph 23 to transfers of financial assets reported in a transferor subsidiary's separate-company financial statements, the term affiliate is used more narrowly than in other authoritative literature (for example, FASB Statement No. 57, Related Party Disclosures).

6 (Popup - Footnote 5)
Q&A 125 Footnote 5—In June 1999, the Board issued an Exposure Draft which would amend Statement 125 and address the impact of removal-of-accounts provisions in determining whether the transferor has surrendered control over transferred financial assets. As reported in FASB Action Alert No. 96-43, dated December 26, 1996, "The Board decided that the [proposed amendment] would require a more restrictive approach to the accounting for credit card securitizations with removal of accounts provisions than has been the practice under Issue 90-18; details of that more restrictive approach will require further Board consideration. The Board acknowledged that the [proposed amendment] would become effective no earlier than upon issuance of the final [amendment] and that determination of whether a transfer of financial assets subject to a removal of accounts provision is accounted for as a sale would continue to be based on the guidance in Issue 90-18 until that time." [Revised 9/99.]

7 (Popup - Footnote 6)
Q&A 125 Footnote 6—In paragraph 129 of Statement 125, "... the Board acknowledge[d] 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."

8 (Popup - Footnote 7)
Q&A 125 Footnote 7—If the dollar-roll repurchase agreement is accounted for as a sale under Statement 125, FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, provides guidance on the subsequent accounting for the forward contract once that Statement has been adopted.

9 (Popup - Footnote 8)
Q&A 125 Footnote 8—Questions 16 and 17 of the FASB Special Report, A Guide to Implementation of
Statement 115 on Accounting for Certain Investments in Debt and Equity Securities, address whether securities classified as held-to-maturity may be pledged as collateral and subject to a repurchase agreement, respectively.

10 (Popup - Footnote 9)
Q&A 125 Footnote 9—Entities should consider the possible effects of FASB Statement No. 134, Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, which amends Statement 65.

11 (Popup - Footnote 1)
Q&A 125 Footnote 10—Whether a beneficial interest is a structured note that should be subsequently measured under Issue 96-12 is a matter of facts and circumstances. This simplified example assumes that application of Issue 96-12 is appropriate for purposes of illustrating the interplay between Statements 115 and 125, and Issue 96-12.

12 (Popup - Footnote 11)
Q&A 125 Footnote 11—The $170 initial investment is equal to the sum of the carrying amount of the equity securities ($150) and the carrying amount of the debt security ($20).

13 (Popup - Footnote 12)
Q&A 125 Footnote 12—Refer to paragraph 83 and Question 66 for guidance on when to recognize a recourse liability.

14 (Popup - Footnote 13)
Q&A 125 Footnote 13—For example, determining the appropriate literature for evaluating impairment is a matter of facts and circumstances. Other literature that might provide the appropriate guidance include FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan, Statement 115, and Statement 133.

15 (Popup - Footnote 14)
Q&A 125 Footnote 14—The other amount is the estimate of the benefits of servicing.

16 (Popup - Footnote 15)
Q&A 125 Footnote 15—To the extent the apparent value of the servicing asset exceeds the value of the cash that would have been received had the transaction been consummated as a cash transaction, it is likely that the fair value of the servicing has been overstated.

17 (Popup - Footnote 16)
Q&A 125 Footnote 16—That restratification of servicing rights is a change in the application of an accounting principle. Paragraph 56 of Statement 133 provides guidance on accounting for that change.