INTRODUCTION

In September 2000, the Financial Accounting Standards Board (FASB) issued Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, which replaces Statement 125 but carries over most of its provisions without reconsideration.

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 140 because of the relatively high number of inquiries received on that Statement and Statement 125.


In March 2006, the FASB issued FASB Statement No. 156, Accounting for Servicing of Financial Assets. Statement 156 requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable, and permits an entity to subsequently measure those servicing assets and servicing liabilities at fair value. The questions and answers in this Special Report have been updated to reflect changes resulting from the issuance of Statement 156.

Questions and Answers

Scope

Q—If a right to receive the minimum lease payments to be received under an operating lease is transferred, could it be considered a financial asset within the scope of Statement 140?

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 140 “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 140? For example, does Statement 140 apply to an entity’s conveyance of mortgage servicing rights that have been separated from an underlying mortgage loan portfolio that the entity intends to retain?


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 140?

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 140.

To explain, a transfer, as defined in ♦ paragraph 364, is “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 140’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 be rare to conclude that debt has been extinguished if the criteria of ♦ paragraph 9 were not also met.

4. Q—Does Statement 140 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.” 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 140.

5. Q—Do the provisions of Statement 140 apply to “desecuritizations” of securities into loans or other 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 140?

A—No. Paragraph 364 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 an obligation by one party on another. This notion in Statement 140 is consistent with the notion discussed in 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, which stated:

Other contingent items that ultimately may require the payment of cash but do not as yet arise from contracts, such as contingent liabilities for tort judgments payable, are not financial instruments. However, when those obligations become enforceable by government or courts of law and are thereby contractually reduced to fixed payment schedules, the items would be financial instruments under the definition.

Securitized stranded costs are not financial assets, and therefore transfers of securitized stranded costs are not within the scope of Statement 140. 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 for the utility, 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 140?

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 that 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 140)?
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 140 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 140 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.)

11. [Deleted 8/01 because FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, eliminates the concept of temporary control.]

Q—Assume that a subsidiary is not consolidated by its parent only because it is temporarily controlled. Would Statement 140 apply to the transfer of that parent’s investment in its nonconsolidated, temporarily controlled investee?

A—Generally, yes.4a(6) Investments in subsidiaries that are not consolidated only because control is temporary are accounted for as cost method investments.5(7) Transfers of cost method investments are within the scope of Statement 140. [Revised 9/01.]

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 12.

12. Q—Would Statement 140 apply to a transfer of an investment in a controlled entity that has not been consolidated by an entity because that entity accounts for its investment in the controlled entity at fair value (for example, a broker-dealer or an investment company)?

A—Generally, yes.5a(8) An entity that carries an investment in a subsidiary at fair value will realize its investment by disposing of it 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 11. [Revised 9/01.]

13. Q—Is a transfer of an equity method investment within the scope of Statement 140?

A—Yes, unless the transfer is of an investment that is in substance a sale of real estate, as defined in FASB Interpretation No. 43, Real Estate Sales.

For transfers of investments that are in substance a sale of real estate, refer to FASB Statement No. 66, Accounting for Sales of Real Estate, APB Opinion No. 29, Accounting for Nonmonetary Transactions, and ♦ EITF Issue No. 01-2, "Interpretations of APB Opinion No. 29." [Revised 9/01; 5/03; 4/05.]

14. 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 financial liability, the transfer (or extinguishment in the case of a liability) of which would be within the scope of Statement 140?

A—Yes. Under Statement 140, 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 364). Statement 140 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 364).

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 financial liability.

15. 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 140 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.

16. Q—Does Statement 140 apply to a transfer of a recognized derivative instrument that is not a financial instrument?

A—Yes. Derivative instruments that are nonfinancial liabilities (for example, a written commodity option) are included in the scope of Statement 140 because paragraph 16 applies to extinguishments of all liabilities.

Although transfers of nonfinancial assets are not within the scope of Statement 140, 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 all assets that are nonfinancial derivative instruments subject to the requirements of Statement 133 should be accounted for by analogy to Statement 125. Statement 125 was replaced by Statement 140 without reconsideration of this matter. Therefore, paragraph 9 and the other provisions of Statement 140 should be applied to determine whether a transferred nonfinancial derivative asset (for example, a purchased commodity option) that is accounted for under Statement 133 should be derecognized.

Similarly, the logic in Question 15 should be applied to transfers of nonfinancial derivative instruments that have the potential to become either assets or liabilities (for example, forward and swap contracts).

Control Criteria

Isolation

17. Q—What type of evidence is sufficient to provide reasonable assurance that transferred assets are isolated beyond the reach of the transferor under Statement 140?

A—Statement 140 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 27 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 27 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. For entities that would be subject to FDIC receivership, refer to Question 19.

18. 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 27 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 consolidated affiliate of the transferor. . . .”

19. Q—Can transferred financial assets be isolated from the transferor if the Federal Deposit Insurance Corporation (FDIC) would be the receiver should the transferor fail?
   A—Yes, depending on the facts and circumstances. Before July 2000, this situation was unclear. In July 2000, the FDIC adopted a final rule, Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation. That final rule modifies the FDIC’s receivership powers so that, subject to certain conditions, it shall not recover, reclaim, or recharacterize as property of the institution or the receivership any financial assets transferred by an insured depository institution that meet all conditions for sale accounting treatment under GAAP, other than the “legal isolation” condition in connection with a securitization or participation.

♦ Paragraphs 159 and 160 of Statement 140 explain that, in light of the FDIC’s issuance of this rule, further specific guidance on this issue is not required. Therefore, the Board removed the guidance that was contained in ♦ paragraphs 58 and 121 of Statement 125.

Therefore, the guidance in paragraphs 27, 28, and 80-84 of Statement 140 applies to transfers by all entities, including institutions for which the FDIC would be the receiver. Subsequent to the issuance of Statement 140, several questions arose regarding the meaning of paragraphs 27, 28 and 80-84. In response the FASB staff issued additional implementation guidance (see Questions 19A-19D). See also FASB Technical Bulletin 01-1, Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets. [Revised 9/01.]

The Audit Issues Task Force Working Group of the AICPA has 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. 140." That update will assist auditors in determining whether the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of the FDIC in light of the FDIC rule. [Revised 9/01.]

19A.*(9) Q—Can assets transferred by an entity subject to possible receivership by the FDIC be
considered isolated from the transferor (that is, can the transfer meet the condition in paragraph 9(a)) if circumstances can arise under which the FDIC or another creditor can require their return?

A—Yes. Assets transferred by an entity subject to possible receivership by the FDIC are isolated from the transferor if the FDIC or another creditor either cannot require return of the assets or can only require return in receivership, after a default, and in exchange for payment of, at a minimum, principal and interest earned (at the contractual yield) to the date investors are paid. However, see Question 19C for guidance if the transferor can require the return of the assets. [Added 9/01.]

19B. *(10) Q—Does the answer to Question 19A also apply to assets transferred by an entity subject to the U.S. Bankruptcy Code?

A—No. Paragraphs 81–83 make clear what is needed for transfers by entities subject to the U.S. Bankruptcy Code to meet the condition in paragraph 9(a) that the transferred assets have been "put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy. . . ." That result differs from the result for an entity subject to possible receivership by the FDIC discussed in Question 19A. However, given the unusual nature of receivership under the FDIC, the Board did not object to that distinction. [Added 9/01.]

19C. *(11) Q—Can assets transferred by any entity be considered isolated from the transferor (that is, can the transfer meet the condition in paragraph (9a)) if circumstances can arise under which the transferor can require their return, but only in exchange for payment of principal and interest earned (at the contractual yield) to the date investors are paid?

A—No, unless the transferor's power to require the return of the assets arises solely from a contract with the transferee. The answer is no, even if the noncontractual power appears unlikely to be exercised or is dependent upon the uncertain future actions of other entities (for example, insufficiency of collections on underlying transferred financial assets or determinations by court of law). Such a noncontractual power is inconsistent with the limitations of paragraph 9(a) of Statement 140 that, to be accounted for as having been sold, transferred financial assets must be isolated from the transferor.

The FASB staff is aware that, under the answer, "single-step" securitizations commonly used by financial institutions subject to receivership by the FDIC and sometimes used by other entities are likely not to be judged as having isolated the assets. One reason for that is because it would be difficult to obtain reasonable assurance that the transferor would be unable to recover the transferred assets under the "equitable right of redemption" available to secured debtors, after default, under U.S. Law. [Added 9/01.]

19D. *(13) Q—Which of those answers applies to entities subject to possible receivership under jurisdictions other than the FDIC or the U.S. Bankruptcy Code?

A—The answer depends on the circumstances that apply to those types of entities. Paragraph 84 of Statement 140 states, "For entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures in the United States or other jurisdiction, judgments about whether transferred assets have been isolated need to be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions." The same sorts of judgments may need to be made in relation to powers of the transferor or its creditors. [Added 9/01.]

20. 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
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. ¶ Paragraph 27 explains that derecognition of transferred financial assets is only appropriate when the assets are isolated from the “transferor or any consolidated affiliate of the transferor 7(14) that is not a special-purpose corporation or other entity designed to make remote the possibility that it would enter bankruptcy or other receivership” (emphasis added). 8(15)

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 a consolidated affiliate of the transferor, and such a transfer could isolate the transferred assets and be accounted for as a sale if all other conditions of paragraph 9 are met.

21. 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

22. Q—Assuming that all of the other requirements of ¶ paragraph 9 are met, has a transferor surrendered control over transferred assets if the transferee (that is not a qualifying special-purpose entity (SPE)) 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 have the right to pledge or exchange the transferred assets. The Board’s reasoning for that condition is explained in ¶ paragraph 161, 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.” As discussed in ¶ paragraphs 168 and 169, the Board concluded that the key concept is “the ability to obtain all or most of the cash inflows, either by exchanging the transferred asset or by pledging it as collateral” (paragraph 169). Also, ¶ paragraph 29 explains that transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained or only on terms agreed with the transferor, also constrain the transferee and presumptively provide the transferor with more-than-trivial benefits.

22A. Q—Assume an entity transfers financial assets to an entity that is not a qualifying SPE. The transferee is significantly limited in its ability to pledge or exchange the transferred assets. The transferor receives cash in return for the transferred assets and has no continuing involvement with the transferred assets—no servicing responsibilities, no participation in future cash flows, no
recourse obligations other than standard representations and warranties that the financial assets transferred met the delivery requirements under the arrangements, no further involvement of any kind. Does the transfer meet the requirements of paragraph 9(b) of Statement 140?

A—Yes. For a transfer to fail to meet the requirements of paragraph 9(b), the transferee must be constrained from pledging or exchanging the transferred asset and the transferor must receive more than a trivial benefit as a result of the constraint. As noted in paragraph 166 of Statement 140, "... transferred assets from which the transferor can obtain no further benefits are no longer its assets and should be removed from its statement of financial position."

For transfers to an entity that is not a qualifying SPE after which the transferor does have any continuing involvement, an evaluation must be made as to whether the requirements of paragraph 9(b), as explained by paragraphs 29–34 of Statement 140, have been met. [Added 9/01.]

23. 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 nature of the requirement for approval. Sale accounting is precluded if conditions imposed by the transferor both constrain a transferee and provide more than a trivial benefit to the transferor. ♦ Paragraph 106 explains that “... if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor presumptively receives a more than trivial benefit, has not relinquished control over the loan, and shall account for the transfers as secured borrowings.”

Some transferor-imposed conditions do not constrain the transferee. ♦ Paragraph 30 states that “a transferor’s right of first refusal on the occurrence of a bona fide offer to the transferee from a third party ...” 9(16) or “... a requirement to obtain the transferor’s permission to sell or pledge that is not to be unreasonably withheld” does not presumptively constrain a transferee. A prohibition on sale to the transferor’s competitor may or may not constrain a transferee from pledging or exchanging the asset depending on how many other potential buyers exist. If there are many other potential willing buyers, the prohibition would not be constraining. In contrast, if that competitor were the only potential willing buyer (other than the transferor), then the condition would be constraining.

Judgment is necessary to determine whether a requirement to obtain the transferor’s permission to sell or exchange should preclude sale accounting.

24. Q—If a qualifying 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 presumptively would not constrain a transferee’s ability to transfer those beneficial interests. The primary limitation imposed by Rule 144A is that a potential buyer must be a sophisticated investor. If a large number of qualified buyers exist, the holder could transfer those securities to many potential buyers and, thereby, realize the full economic benefit of the assets. In such circumstances, the requirements of Rule 144A would not be a constraint that precludes sale accounting under ♦ paragraph 9(b).
Limits on Permitted Activities

24A. Q—Is it permissible for another entity to perform activities on behalf of a qualifying special-purpose entity (SPE) or to direct the qualifying SPE to perform activities—that otherwise would not be permitted activities of the qualifying SPE?

A—No. The significant limitations on the activities of a qualifying SPE required by Statement 140 apply whether those activities are carried out by the qualifying SPE itself or by its agent or anyone else acting on its behalf. [Added 9/01.]

25. 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, which may be the 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 35 of Statement 140. A transferor’s or servicer’s having discretion to select which loans to remove to reposition a portfolio is beyond those powers set forth in paragraph 35(d)(1) of Statement 140. Sale accounting would also be precluded under the provisions of paragraphs 9(c)(2), 54, and 86(a) of Statement 140 because such a power gives the transferor the unilateral right to reclaim specific assets from the qualifying SPE.

25A. Q—Can a servicer of assets held by a qualifying SPE have discretion in disposing of defaulted loans? Is that ability consistent with the restriction on a qualifying SPE?

A—No. Paragraph 35(d)(1), as illustrated in paragraph 43(a) of Statement 140, specifically prohibiting qualifying SPE from having discretion in disposing of defaulted loans (or other financial assets). However, if the servicing agreement in effect at the time the SPE was established describes specific conditions in which a servicer of a defaulted loan is required to dispose of the loan and the servicer has no choice but to dispose of the defaulted loan when the described conditions occur, then such a loan disposal is a permitted activity of qualifying SPE. [Added 9/01.]

25B. Q—Some servicing agreements require the servicer to either dispose of or hold (work out or foreclose) defaulted nonrecourse loans secured by commercial real estate based on the result of a net present value (NPV) computation that is designed to maximize the return on the defaulted loan. Is the rule described in this question consistent with the requirements of paragraph 35(d)(1) of Statement 140?

A—No. To analyze a compound rule like that described in this question, all possible outcomes should be analyzed and each possible outcome must comply with paragraph 35(d)(1).

It is also necessary to consider the overall process involved when determining whether a rule is an automatic response. In many of the decision rules that could be formulated (including the example in the question), the value or other inputs must be estimated. Depending on the nature of the inputs and the sophistication of the judgment required to obtain or filter those inputs, a specific decision rule may not be automatic and therefore not meet the requirements of paragraph 35(d)(1). Indicators that such inputs are not automatic for the purposes of paragraph 35 include the need for the involvement of highly experienced personnel and the existence of provisions that permit other beneficial interest holder (BIHs) to review and challenge those inputs.

For example, the specific fact pattern referred to in this question, in which significant judgment is required to estimate the inputs to the computation, leads to the conclusion that the decision rule is not automatic. In that case, significant judgments are required in estimating future vacancy and
rental rates, the projected timing and sale price of foreclosed property, and the terms of a workout arrangement still to be negotiated, all of which are input into the NPV model. [Added 9/01.]

**Derivative Financial Instruments**

26. **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 those transactions (a) result in derivative financial instruments that are passive in nature and pertain to beneficial interests issued or sold to entities other than the transferor, its affiliates, or its agents; (b) do not create conditions that violate the provisions of paragraphs 35(c)(2) and 35(d); and (c) provide in its legal documents the powers of the SPE to enter into derivative transactions. Refer to Questions 27 and 28.

To illustrate, a qualifying SPE is precluded from entering into written options that provide the holder with an opportunity to trigger a condition that enables the SPE to sell transferred assets under circumstances inconsistent with the requirements of paragraph 35(d)(2) of Statement 140.

If an SPE enters into certain derivative instruments, 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 instruments include:

- Derivative instruments that preclude the transferor from achieving legal isolation under paragraph 9(a)
- Derivative instruments through which the transferor retains effective control over the transferred assets under paragraph 9(c).

27. **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**—Generally, no. As discussed in Question 26, a qualifying SPE can enter into derivative transactions at the time beneficial interests are issued under paragraph 35(c)(2) as interpreted by paragraphs 39 and 40. However, a derivative entered into by the qualifying SPE at the time beneficial interests were issued may only be replaced upon occurrence of a pre-specified event or circumstance outside the control of the transferor, its affiliates, or its agents (for example, a default by the derivative counterparty) as specified in the legal documents that established the qualifying SPE.

28. **Q**—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. Paragraph 35(d)(1) (as interpreted by paragraphs 42 and 43) limits a qualifying SPE’s ability to sell (or otherwise dispose of) noncash financial assets held by it to situations where there is, or is expected to be, a “decline by a specified degree below the fair value of those assets when the SPE obtained them” (emphasis added). Derivative instruments designed to effectively realize gains would be inconsistent with this provision. Refer to Questions 26 and 27.

**Servicing Activities**

28A. **Q**—Sometimes, a servicer or other BIH in a qualifying SPE retains the right (an option) to purchase defaulted loans (that is, through physical settlement— in some cases for a fixed amount and in other cases at fair value). Are such options consistent with the restrictions on a qualifying SPE?
A—Yes. If the party holding the default call option is the transferor (or its affiliates or its agents), the option is a default removal-of-accounts provision (ROAP) or other physically settled contingent call option that is specifically permitted by paragraph 35(d)(3) of Statement 140. The determination of how that kind of option affects the accounting by the transferor is complex, and it is necessary to consider the overall effect of related rights and obligations in making that assessment. See Question 49 for guidance on how the transferor is affected by such options.

If a party other than the transferor, its affiliates, or its agents holds the default call option, that right is a beneficial interest. Paragraph 44(a) of Statement 140 permits a qualifying SPE to dispose of assets in response to a BIH (other than the transferor, its affiliates, or its agents) exercising its right to put its beneficial interest back to the qualifying SPE in exchange for a full or partial distribution of the assets held by the qualifying SPE. The fact that the holder of the option must also pay cash (equal to the option's exercise price, which may be the fair value of the underlying financial instrument) in the exchange should not result in a different conclusion in applying paragraph 44(a). [Added 9/01.]

28B. Q—When a loan becomes delinquent or defaults, the servicer typically attempts to restructure or "work out" the loan in lieu of foreclosing on the collateral. Is the discretion permitted a servicer to work out a loan consistent with the limited powers permitted a qualifying SPE?

A—Yes. A servicer may have discretion in restructuring or working out a loan as long as that discretion is significantly limited and the parameters of that discretion are fully described in the legal documents that established the qualifying SPE or that created the beneficial interests in the transferred assets. However, the servicer may not initiate new lending to the borrower through the qualifying SPE as a result of the workout. (Refer to paragraph 185 of Statement 140.) Examples of activities that are not new lending are:

- Payments made by a servicer after a debtor fails to pay them (for example, to pay delinquent property taxes, to ensure required property and casualty insurance coverage is maintained, and so forth) that are contemplated in the lending agreement prior to its transfer to the qualifying SPE.
- Advances of funds by servicers (whether required or discretionary) to facilitate timely payments to the beneficial interest holders, after which the servicer has a priority right to recoup its advances from future cash inflows. That activity does not represent new lending activity to the borrower because it does not increase the indebtedness of the borrower.
- Extension of further credit by a transferor in a credit card securitization or revolving-period securitization and the subsequent transfer of the resulting loan by the transferor to qualifying SPEs, pursuant to agreements in the legal documents that established the qualifying SPE. That is not a new lending activity by a qualifying SPE because the loan is originated by the transferor, not through the qualifying SPE. [Added 9/01.]

28C. Q—Is the decision to initiate foreclosure activities a servicing activity or a disposal of a loan?

A—It is a servicing activity. Foreclosure is a means by which the servicer attempts to collect principal and interest due on a loan. It is not a loan disposal. A servicer may have discretion in determining when to initiate foreclosure proceedings as long as that discretion is significantly limited and the parameters of that discretion are fully described in the legal documents that established the qualifying SPE or that created the beneficial interests in the transferred assets. [Added 9/01.]

28D. Q—May a servicer of assets held by a qualifying SPE have some discretion in managing and disposing of foreclosed assets?
A—Yes. A servicer may have discretion to dispose of foreclosed assets that it temporarily holds (as long as that discretion is significantly limited and the parameters of that discretion are fully described in the legal documents that established the qualifying SPE or that created the beneficial interests in the transferred assets).

However, certain activities that could be undertaken by a servicer managing foreclosed assets are inconsistent with the discretion permitted a qualifying SPE because they are inconsistent with the provisions of paragraphs 35 and 37 of Statement 140. Judgment needs to be applied to determine whether a specific activity is inconsistent with those provisions.

29. 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. Holding servicing rights to financial assets that it holds is a permitted activity for qualifying SPEs under ♦ paragraph 35(c)(5) (as interpreted by ♦ paragraph 41). ♦ Paragraph 61 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. [Refer to Question 28A.] [Revised 9/01.]

Limits on What a Qualifying SPE May Hold

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

A—Generally not. Entities account for an investment in accordance with the equity method if 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. Qualifying SPEs are limited to holding passive investments in financial assets. ♦ Paragraph 39 of Statement 140 notes that “investments are not passive if through them . . . the SPE or any related entity . . . is able to exercise control or significant influence . . .” (emphasis added). However, that limitation does not apply to certain investments that are accounted for (for example, under EITF ♦ Topic No. D-46, “Accounting for Limited Partnership Investments”) in accordance with the equity method, even though the investor does not have the ability to exercise significant influence. Refer to Question 41.

Unilateral Rights Held by the Transferor

31. Q—Credit card securitizations often include a “removal-of-accounts” provision (ROAP) 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—it depends on the rights that the transferor has under the ROAP. A ROAP that does not allow the transferor to unilaterally reclaim specific assets from the qualifying SPE, as described in ♦ paragraphs 35(d)(3), 51–54, and 87, does not preclude sale accounting. ♦ Paragraph 86 provides examples of ROAPs that would allow the transferor to unilaterally reclaim specific transferred assets and preclude sale accounting. Refer to Question 49.

32. Q—If a transferor’s retention of beneficial interests in financial assets transferred to a non-qualifying SPE that cannot pledge or exchange its assets permits the transferor to dissolve the SPE and reassert control of the assets at any time, is the transferor precluded from accounting for the transfer as a sale?

A—Yes, for two reasons. First, because the SPE cannot pledge or exchange the assets (it is not a qualifying SPE) and this restriction provides the transferor with the more than trivial benefit of
knowing that the assets (which it is entitled to reacquire) must remain in the SPE, sale accounting is precluded under paragraph 9(b).

Second, the transferor’s current ability to dissolve the SPE and reassume control of the assets entitles it to unilaterally cause the return of the transferred assets, which precludes sale accounting under paragraph 9(c)(2).

**Beneficial Interests**

33. **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 75 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 173 explains that:

Qualifying SPEs issue beneficial interests of various kinds—variously characterized as debt, participations, residual interests, and otherwise—as required by the provisions of those agreements.

34. **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 35, an SPE can issue beneficial interests, including those in the form of debt securities or equity securities, and be considered qualifying. Paragraph 364 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, commercial paper obligations, and residual interests, whether in the form of debt or equity.

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 35.

35. **Q**—May a debtor derecognize a liability (without having to recognize another, similar 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 140. 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 140. 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 140:

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) 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.

Consolidated Financial Statements

36. 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 35 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. If a qualifying SPE serves as a conduit for different transferors, each condominium is effectively a qualifying SPE. Therefore, each transferor applies the consolidation guidance in ♦ paragraph 46 of Statement 140 to its condominium. Refer to Question 60.

37. Q—Should a qualifying SPE be consolidated by the transferor or its affiliates?

A—No. ♦ Paragraph 46 states that “a qualifying SPE shall not be consolidated in the financial statements of a transferor or its affiliates” (emphasis added).

♦ Paragraph 25 of Statement 140 permits a formerly qualifying SPE that fails to meet one or more conditions for being a qualifying SPE to be considered a qualifying SPE if it maintains its qualifying status under previous accounting standards, does not issue new beneficial interests after the effective date, and does not receive assets it was not committed to receive before the effective date. Otherwise, a formerly qualifying SPE and assets transferred to it shall be subject to other consolidation policy standards and guidance, and to all provisions of Statement 140.

Beneficial interest holders, sponsors, servicers, and others involved with a qualifying SPE that are not affiliated with the transferor should apply Interpretation 46 to determine whether they should consolidate a qualifying SPE if they meet the requirements in ♦ paragraph 4(d) of Interpretation 46. [Revised 4/03.]

38. Q—Should a transferor apply Statement 140’s consolidation provisions 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. The conditions for sale accounting in paragraph 9 are irrelevant to determining whether a
transferee is a qualifying SPE and whether it should be consolidated.

The result of applying Statement 140 if financial assets are transferred to a qualifying SPE in transactions that were accounted for by the transferor as secured borrowings is that the qualifying SPE would not be consolidated by the transferor and the assets transferred to the qualifying SPE would continue to be recognized by the transferor because the conditions for sale accounting have not been met.

39. Q—If a transferor subsequently transfers all the equity interests in a previously unconsolidated qualifying SPE to an unrelated third party, would that third party be able to use Statement 140 as its basis for evaluating consolidation accounting?

A—No. ♦ Paragraph 46 of Statement 140 is limited to consolidation by the “transferor or its affiliates.” If that third party "has the unilateral ability to cause the entity to liquidate or to change the entity so that it no longer meets the conditions in paragraph ♦ 25 or ♦ 35 of Statement 140," the requirements of Interpretation 46 apply. [Revised 4/03.]

40. 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 fair value of the beneficial interests issued by the qualifying SPE?

A—No. ♦ Paragraph 46 provides that “a qualifying SPE shall not be consolidated in the financial statements of a transferor or its affiliates.” That provision does not make a distinction based on the proportion of the qualifying SPE’s beneficial interests that are retained by the transferor. However, ♦ paragraph 36 provides that if the transferor holds more than 90 percent of the fair value of the beneficial interests, that would preclude the SPE from being a qualifying SPE unless the transfer is a guaranteed mortgage securitization.

41. 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 an 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. Use of the equity method under Opinion 18 presumes that Company A has significant influence over Company B. Under Statement 140, Company A cannot be a qualifying SPE if it holds investments that allow it or others to exercise control or significant influence over the investee. Would Company A be precluded from applying the consolidation guidance in Statement 140 to that SPE? Would it make a difference if Company A’s ownership interest in Company B is reduced to a level such that the investment is no longer accounted for under the equity method after the transfer?

A—Yes and perhaps, respectively.

Yes, Company A is precluded from applying the consolidation guidance in Statement 140 to that SPE because the SPE is not a qualifying SPE. A qualifying SPE may hold only passive instruments. ♦ Paragraph 39 explains that:

Investments are not passive if through them, either in themselves or in combination with other investments or rights, the SPE or any related entity, such as the transferor, its affiliates, or its agents, is able to exercise control or significant influence . . . over the investee.

However, if as a result of the transfer, the transferor, the SPE, and any other related entities in combination cannot exercise significant influence or control over the investee, and the SPE meets the other requirements of Statement 140 to be a qualifying SPE, the transferor would apply the consolidation provision of ♦ paragraph 46. Refer to Question 30.
Effective Control

42. Q—Dollar-roll repurchase agreements (also called dollar rolls) are agreements to sell and repurchase similar but not identical securities. Dollar rolls differ from regular repurchase agreements in that the securities sold and repurchased, which are usually of the same issuer, are represented by different certificates, are collateralized by different but similar mortgage pools (for example, conforming single-family residential mortgages), and generally have different principal amounts. Is a transfer of financial assets under a dollar-roll repurchase agreement within the scope of Statement 140?

A—A transfer of financial assets under a dollar-roll repurchase agreement is within the scope of Statement 140 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 140 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 Statement 133 or EITF Issue No. 84-20, “GNMA Dollar Rolls,” may apply to what are considered Type 4 securities by that Issue. Any type of Type 4 contracts that are not subject to Statement 133’s provisions must be marked to market as required by Issue 84-20.

43. Q—Does paragraph 9(c)(1) preclude sale accounting for a dollar-roll transaction that is subject to the provisions of Statement 140?

A—The answer depends on the facts and circumstances. For paragraph 9(c)(1) to preclude sale accounting, pursuant to paragraph 47(a), “the assets to be repurchased or redeemed [must be] the same or substantially the same as those transferred.” Paragraph 48 describes six characteristics that must all exist in order for a transfer to meet the substantially-the-same requirement in paragraph 47(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. Another is that the transferor must be able to repurchase or redeem the transferred assets on substantially the agreed terms, even in default by the transferee. Refer to Question 45.

44. 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 from accounting for the transfer as a secured borrowing?

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 determine that the transferee holds the securities that it has committed to return.

45. Q—Paragraph 49 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 transferor?

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 49, the requirement of paragraph 9(c)(1) would not be met and sale accounting by the transferor would not be precluded unless the arrangement assures, by contract or custom, that the collateral is sufficient “at all times . . . to fund substantially all of the cost of purchasing replacement assets from others.”

Statement 140 does not prescribe that a specific contractual term, such as a margining provision, must be present to meet the sufficient collateral requirement. Instead, Statement 140 prescribes, as explained in ˈ paragraph 218, what the effect of the arrangement must be—that the transferor “is protected by obtaining collateral sufficient to fund substantially all of the cost of purchasing identical replacement securities during the term of the contract so that it has received the means to replace the assets even if the transferee defaults.” Simply excluding a margining provision from a repurchase agreement does not change the accounting that results if the maintenance of sufficient collateral is otherwise assured. For example, a contractual provision that a repurchase agreement is immediately terminated should the value of the collateral become insufficient to fund substantially all of the cost of purchasing replacement assets would satisfy the requirement in ˈ paragraph 49.

46. Q—ˈ Paragraph 49 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 140. 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 ˈ paragraph 218, “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 218 further states:

. . . 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 the 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.

47. Q—Does Statement 140 contain special provisions for differences in collateral maintenance requirements that exist in markets outside the United States?

A—No. The general provisions of Statement 140 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 ˈ paragraph 9(c)(1) only if the transfer involves an agreement that both entities and obligates the transferor to repurchase or redeem the assets before maturity and all of the requirements of ˈ paragraphs 47–49 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 140 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.

48. Q—Paragraph 9(c)(1) of Statement 140 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 140?

A—Statement 140 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 213 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).

49. Q—How do different types of rights of a transferor to reacquire (call) transferred assets affect sale accounting under Statement 140?

A—Sale accounting is precluded if a right to reacquire (call) a transferred asset has any of three effects:

1. A condition both constrains the transferee from taking advantage of its right to pledge or exchange the transferred asset(s) and provides more than a trivial benefit to the transferor (paragraph 9(b)).
2. The transferor maintains effective control through an agreement that both entitles and obligates it to redeem transferred asset(s) before their maturity (paragraph 9(c)(1)).
3. The transferor maintains effective control through the ability to cause, unilaterally, the return of specific transferred assets (paragraph 9(c)(2)).

A unilateral right to reclaim specific transferred assets precludes sale accounting only for transferred assets that the transferor has the unilateral right to reacquire. Paragraph 52 states that clearly: “. . . a call on specific assets transferred to a qualifying SPE . . . maintains that transferor’s effective control over the assets subject to that call” (emphasis added). Further, a right to reclaim specific transferred assets precludes sale accounting only if the transferor can exercise the right unilaterally. The following table summarizes Statement 140’s provisions for different types of rights of a transferor to reacquire (call) transferred assets, including references to paragraphs in the Statement that provide more detail.

**Effective Control over Transferred Asset(s) through an Option or Repurchase Agreement**
<table>
<thead>
<tr>
<th>Transferor holds . . .</th>
<th>Non-QSPE</th>
<th>QSPE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unconditional Attached Call [¶364] (fixed price)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>—on all transferred assets</td>
<td>No sale. [¶(c)(2)]</td>
<td></td>
</tr>
<tr>
<td>—on a portion of the assets and:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-can choose assets</td>
<td>No sale on covered assets: [¶(c)(2); ¶52; ¶86(a)]</td>
<td></td>
</tr>
<tr>
<td>-cannot choose assets</td>
<td>Sale of part of the assets: [¶(c)(2); ¶52; ¶87(a)]</td>
<td></td>
</tr>
<tr>
<td><strong>Unconditional Embedded Call [¶364] (fixed-price)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>—in assets (embedded by issue)</td>
<td>Does not preclude sale. [¶50]</td>
<td></td>
</tr>
<tr>
<td>—in QSPE beneficial interests (embedded by QSPE)</td>
<td>Not applicable.</td>
<td>Effectively an attached call [¶51]</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Analyze under those provisions.</td>
</tr>
<tr>
<td><strong>Unconditional Freestanding Call [¶364] (fixed-price)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>—on assets readily obtainable</td>
<td>Does not preclude sale. [¶(b); ¶(c)(2); ¶32]</td>
<td>Effectively an attached call [¶51]</td>
</tr>
<tr>
<td>—on assets not readily obtainable</td>
<td>No sale. [¶(b); ¶32]</td>
<td>Effectively an attached call [¶51]</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Analyze under those provisions.</td>
</tr>
</tbody>
</table>

**ROAPs**

- unconditional
  - Analyze as if it were either an attached or freestanding unconditional call.

- conditional
  - Reanalyze as an unconditional call when the condition is resolved.

**Exceptions**

- Cleanup call
  - Does not preclude sale. [¶(c)(2); ¶364]

- Fair value call (no residual interest)
  - Does not preclude sale unless it constrains the transferee. [¶(c)(2); ¶52; ¶53]

- Conditional call
  - Does not preclude sale. Reanalyze provision when condition resolved.

**Other Rights to Reclaim Assets**

- Forward purchase agreement:
  - No sale. [¶(c)(1); ¶47–49]

- Without collateral maintenance
  - Analyze as either an attached or freestanding call. [¶(c)(2)]

- Auction where transferor holds residual
  - Analyze as either an attached or freestanding call. [¶(c)(2); ¶33]

- Right of first refusal
  - Reanalyze as an unconditional call when the condition is resolved. [¶30]

*Unless the call is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it.
† Some attached call options become exercisable (1) when the balance of the transferred pool or asset remaining reaches a specified level or (2) at a specified date. Possible credit losses or prepayments may make uncertain (a) the time until the option is exercisable or (b) the proportion of the pool or asset that will then remain, respectively. If such an option maintains the transferor’s effective control over a portion of the transferred assets, the portion of the transferred assets to be derecognized and retained should be based on the relative fair values of (a) cash flows expected to be distributed to third-party beneficial interest holders before the option becomes exercisable and (b) the balance of future cash flows expected to remain when the option becomes exercisable.
‡ Conditional ROAPs are rights to reclaim assets that the transferor does not have the unilateral right to exercise.
§ Unless the transferor can trigger activation of the right (see footnote 15 of Statement 140). In that case, the right should be analyzed as an in-substance call option.

Examples of Application of Effective Control Principles to ROAPs

- An unconditional ROAP that allows the transferor to specify the assets that may be removed precludes sale accounting for all assets that might be specified, because such a provision allows the transferor unilaterally to remove specific assets (¶ paragraph 86(a)). That applies even if the transferor’s right to remove specific assets from a pool of transferred assets is limited, say, to 10 percent of the fair value of the assets transferred and all of the assets are smaller than that 10 percent: none of the transferred assets would be derecognized at the time of transfer because no transferred asset is beyond the reach of the transferor. If the transferor reclaims all the assets it can
and thereby extinguishes its option, its control has expired and the rest of the assets have been sold at that time.

- A ROAP for random removal of excess assets provides the right to random removal of excess assets from a pool of transferred assets up to 10 percent of the fair value of the assets transferred (all assets in the pool are smaller than this 10 percent). The transferor has no other interest in the pool. The transferor has, in essence, retained a 10 percent interest in the pool and should account for it as such.

- A ROAP conditioned on a transferor’s decision to exit some portion of its business precludes sale accounting for all assets that might be affected, because it permits the transferor unilaterally to remove specific assets (paragraph 86(b)).

- A ROAP for defaulted receivables does not preclude sale accounting at the time of transfer, because the removal would be allowed only after a third party’s action (default) and could not be caused unilaterally by the transferor (Cleaning paragraph 87(b)). Once the default has occurred, the transferor would have the unilateral ability to remove those specific assets and would need to recognize the defaulted receivable.

- A ROAP conditioned on a third-party cancellation, or expiration without renewal, of an affinity or private-label arrangement does not preclude sale accounting at the time of transfer because the removal would be allowed only after a third party’s action (cancellation) or decision not to act (expiration) and could not be caused unilaterally by the transferor (paragraph 87(c)). Once the cancellation or expiration has occurred, the transferor would have the unilateral ability to remove specific assets and would need to recognize those financial assets.

Other Examples of Application of Effective Control Principles

- In a loan participation, the lead bank (that is also the transferor) allows the participating bank to resell but reserves the right to call at any time from whoever holds it and can enforce the call by cutting off the flow of interest at the call date; such a call precludes sale accounting.

- A call permits the transferor to reclaim all of the transferred assets from the qualifying SPE at any time; such a call precludes sale accounting.

- A transferor-servicer has the right to call the assets in the pool when it amortizes to 20 percent of its value (determined at the date of transfer). The transferor-servicer determines that at that level of assets, its cost of servicing them would not be burdensome in relation to the benefits of servicing, and therefore that the call is not a cleanup call (Cleaning paragraph 364). The transferor-servicer has retained a 20 percent subordinated interest in the pool and should account for it as such.

- If the third-party beneficial interests contain an embedded option and the transferor holds the residual interest in the qualifying SPE, the combination has the same kind of effective control as a scheduled auction provision if the transferor holds a residual interest (refer to Cleaning paragraph 53). Sale accounting would be precluded for all of the transferred assets or, if only part of the assets will remain when the option can be exercised, for the portion that would be subject to the call.

- If the third-party beneficial interests in a qualifying SPE pay off first (a so-called turbo structure, where principal payments and prepayments are allocated on a non–pro rata basis), the transfer could be viewed as meeting the requirements of Cleaning paragraph 52. To some extent, these repayments are contractual cash flows of the underlying assets, but repayments also result from prepayments in the underlying assets (that is, the prepayment options in the underlying assets are mirrored in the third-party beneficial interests). In this case, call options embedded in the third-party beneficial interests result from the options embedded in the underlying assets (that is, they are held by the underlying borrowers rather than the transferor), and thus do not preclude sale accounting to the extent of the third-party interests.

50. Q—In certain transactions, the transferor is entitled to repurchase a transferred amortizing, individual (specific) financial asset when its remaining principal balance reaches some specified amount, for example, 30 percent of the original balance. To exercise that call, the transferor would...
pay the remaining principal balance. Under Statement 140, is such a transfer to be accounted for partially as a sale and partially as a secured borrowing?

**A—** Yes. Statement 140 requires a transferred amortizing, individual financial asset to be bifurcated in the manner described if the transferor is entitled to repurchase part of it, assuming the other provisions of paragraph 9 have been met. Under paragraph 9(c)(2), a call attached to specific transferred assets at a fixed price results in the transferor’s maintaining effective control over the transferred assets subject to that call and, therefore, precludes sale accounting. In this case, the specific asset over which the transferor retains control is the remaining principal balance once the asset amortizes to the specified threshold. The transferor has no effective control over the portion of the financial asset that will be collected before then, so the transfer of that portion of the asset should be accounted for as a sale.

Similarly, if a transferor holds an attached call option to repurchase the individual loans that remain from an entire portfolio of prepayable loans that were transferred in a securitization transaction, once prepayments have reduced the portfolio balance to some specified amount, then sale accounting is precluded only for the transfer of the remaining principal balance subject to the call, not the whole portfolio of loans.

Also similarly, if a transferor holds a call option to repurchase at any time a few specified, individual loans from an entire portfolio of loans transferred in a securitization transaction, then sale accounting is precluded only for the specified loans subject to the call, not the whole portfolio of loans. In contrast, if the transferor holds a call option to repurchase from the portfolio any loans it chooses, up to some specified limit, then paragraph 86(a) of Statement 140 precludes sale accounting for the transfer of the entire portfolio while that option remains outstanding. Refer to Questions 49 and 55.

51. **Q—** Would a transferor’s contractual right to repurchase, at any time, a loan participation that is not a readily obtainable asset preclude sale accounting?

**A—** Yes, except in the unlikely circumstance that the contractual right is freestanding and does not constrain the transferee. As explained in paragraph 106, a loan participation can only be accounted for as a sale if all of the criteria in paragraph 9 are met. Paragraph 9(b) provides that each transferee must have the right to pledge or exchange the assets it received and that no condition both constrains the transferee from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor. The transferor’s contractual right to repurchase is effectively a call option, and paragraph 32 notes that a freestanding call option written by a transferee to the transferor benefits the transferor and, if the transferred assets are not readily obtainable in the marketplace, is likely to constrain a transferee. Furthermore, if the transferor’s right to repurchase is not freestanding but rather attached to and transferable with the participation, paragraph 9(c)(2) precludes sale accounting for transfers in which the transferor maintains effective control over the transferred assets through “the ability to unilaterally cause the holder to return specific assets. . . .” Paragraph 50 states that while such an attached call may not constrain a transferee, it could result in the transferor’s maintaining effective control over the transferred asset “because the attached call gives the transferor the ability to unilaterally cause whoever holds that specific asset to return it.” Refer to Question 49.

52. **Q—** In certain industries, a typical customer’s borrowing needs often exceed its bank’s legal lending limits. 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 unilateral ability to reclaim specific transferred assets?

A—No. Although the concept (unilateral ability to reclaim specific transferred assets) in paragraph 9(c)(2) of Statement 140 is broader than the concept it replaces (an agreement that entitles the transferor to repurchase transferred assets that are not readily obtainable) in paragraph 9(c)(2) of Statement 125, the lead bank is not in a position to unilaterally reclaim the specific transferred assets. Although the participating bank may choose to comply with the lead bank’s request, and may be motivated to do so, for example, by the prospect of future business dealings, it is not contractually obligated to comply. Whether the transferor benefits from knowing where the assets are is not relevant, since the informal understanding does not constrain the transferee from selling or pledging the assets.

53. Q—Under Statement 140, 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 140 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.\[14(21)]

Whether a transfer of a debt security is accounted for as a sale under Statement 140 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 47–49, which are an integral part of the standards in 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.

54. Q—Can a transferor recognize a sale for a transfer of assets to a qualifying SPE if it holds a call option that is “embedded” in the beneficial interests issued by the qualifying SPE?

A—Not if, under its price and terms, the call conveys more than a trivial benefit to the transferor, as discussed in paragraphs 52 and 53. Paragraph 52 states that “for example, if an embedded call allows a transferor to buy back the beneficial interests of a qualifying SPE at a fixed price, then the transferor remains in effective control of the assets underlying those beneficial interests.” Refer to Question 49.

55. Q—Assuming that all of the other criteria of paragraph 9 are met, is sale accounting appropriate if a “cleanup call” on a pool of assets in a qualifying SPE 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 or an affiliate of the servicer is adversely affected by the amount of transferred financial assets declining to a “low level.” If such a transferor has a call exercisable when assets decline to a specified low level, could that be a cleanup call?

A—No. Paragraph 364 defines a cleanup call as follows:
An option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in a qualifying SPE (or in a series of beneficial interests in transferred assets within a qualifying SPE), if the amount of outstanding assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing. [Emphasis added.]

Therefore, the transferor’s call on the assets in the qualifying SPE is not a cleanup call for accounting purposes because it is not the servicer or an affiliate of the servicer.

However, the call option only partially precludes sale accounting because the call option can only be exercised when the assets amortize to a pre-specified level.

As a result, assuming the transfer met the other provisions of paragraph 9, the transferor would record the transfer as a partial sale. Refer to Questions 49 and 50.

56. 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 a cleanup call. Refer to Question 55.

Measurement of Assets and Liabilities upon Completion of a Transfer

57. 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 140?

A—No. Not only would this exchange not be a sale, it might not even be a transfer under Statement 140. If the exchange described is with the trust that initially issued the beneficial interests, then the exchange is not a transfer under Statement 140. ♦ Paragraph 364 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.

58. Q—How should transferred components of financial assets and interests that continue to be held by a transferor be accounted for upon completion of a transfer? [Revised 3/06.]

A—Upon completion of a transfer, the transferor continues to carry in its statement of financial position any interests it continues to hold in the transferred assets, including beneficial interests in assets transferred to a qualifying SPE in a securitization and undivided interests, pursuant to ♦ paragraph 10 of Statement 140. Paragraph 10 also requires upon completion of a transfer of financial assets that a transferor initially recognize and measure at fair value, if practicable, servicing assets and servicing liabilities that require recognition under ♦ paragraph 13 of Statement 140. It also requires that the transferor allocate the previous carrying amount between the assets sold, if any, and the interests that continue to be held by the transferor, if any, based on
their relative fair values at the date of transfer. [Revised 3/06.]

♦ Paragraph 11 of Statement 140 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. ♦ Paragraph 56 of Statement 140 states that proceeds from a sale of financial assets consist of the cash and any other assets obtained, including separately recognized servicing assets, in the transfer less any liabilities incurred, including separately recognized servicing liabilities. [Revised 3/06.]

Interests that continue to be held by a transferor and assets obtained and liabilities incurred upon completion of a transfer of financial assets should be recognized separately. Statement 140 focuses “principally on the initial recognition and measurement of assets and liabilities that result from transfers of financial assets (♦ paragraph 306 of Statement 140). Statement 140 addresses subsequent measurement for servicing assets and servicing liabilities in paragraphs ♦ 13A and ♦ 63(d)–63(g). 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:

• Interest-only strips, interests that continue to be held by a transferor in securitizations, loans, other receivables, or other 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 (except for instruments that are within the scope of Statement 133) should be initially recognized according to ♦ paragraphs 10 and 11 of Statement 140 and, pursuant to ♦ paragraph 14 of Statement 140, subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended by Statement 140.

• Equity securities that have readily determinable fair values should be initially recognized according to paragraphs 10 of Statement 140 (if they are interests that continue to be held by a transferor) and 11 of Statement 140 (if they are received as proceeds of the transfer) and subsequently measured in accordance with Statement 115.

• Debt securities should be initially recognized according to paragraph 10 of Statement 140 (if they are interests that continue to be held by a transferor) or paragraph 11 of Statement 140 (if they are received as proceeds of the transfer) and subsequently measured in accordance with Statement 115, FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities, as amended by FASB Statement No. 134, Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments, and EITF ♦ Issue No. 99-20, “Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets,” as applicable.

• Derivative financial instruments should be initially recognized at fair value (according to ♦ paragraph 56 of Statement 140) and subsequently measured in accordance with existing accounting pronouncements and related guidance on derivative instruments including Statement 133. [Revised 3/06; 6/06.]

59. 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 an interest that continues to be held by a transferor? [Revised 3/06.]

A—♦ Paragraph 58 states that “if a transferor cannot determine whether an asset is an interest that continues to be held by a transferor or proceeds from the sale, the asset shall be treated as proceeds from the sale. . . .” ♦ Paragraph 56 states that “all proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.” [Revised 3/06.]
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 40 percent beneficial interest in the qualifying SPE entitling each participant to a 40 percent interest in each cash flow (that is, each beneficial interest holder receives the same tranche of the trust certificates and is entitled to 40 cents of each dollar collected). Investor C (who is not an affiliate or agent of either transferor) invests cash in return for the last beneficial interest (which gives it the right to receive 20 cents of each dollar collected). The cash invested by Investor C is distributed pro rata to Transferors A and B at the transfer date.

What is the basis for determining whether a beneficial interest in transferred financial assets is a new asset or an interest that continues to be held by a transferor in a securitization structure that commingles assets? [Revised 3/06.]

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 interests that continue to be held by the transferor. 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. [Revised 3/06.]

In the example provided, Transferor A would treat 50 percent of its beneficial interests as interests that continue to be held by the transferor and 50 percent of its beneficial interests as new assets (proceeds from the transfer). Transferor A would also treat the cash received at the transfer date as proceeds. [Revised 4/02; 3/06.]

The Board acknowledges that determining whether a beneficial interest in a securitization is a new asset or an interest that continues to be held by a transferor may be difficult. ♦ Paragraph 272 explains:

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 agreed 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.

[Revised 3/06.]

As part of its response to those issues, the Board decided to include in ♦ paragraph 58 the default provision that “if a transferor cannot determine whether an asset is an interest that continues to be held by a transferor or proceeds from the sale, the asset shall be treated as proceeds from the sale. . . .” In the case of commingled transfers from different transferors, each transferor to a qualifying SPE is eligible to apply the consolidation guidance in ♦ paragraph 46 of Statement 140. Refer to Question 36. [Revised 3/06.]

An entity transfers debt securities to a qualifying SPE that has a predetermined life in exchange for (a) cash and (b) the right to receive proceeds from the eventual sale of the securities. For example, a third party holds a beneficial interest that is initially worth 25 percent of the fair
value of the assets of the qualifying SPE at the date of transfer. The qualifying SPE is required to sell the transferred securities at a predetermined date and liquidate the qualifying SPE at that time. Assume the facts in that example and the following additional facts:

- The beneficial interests are issued in the form of debt securities.
- Prior to the transfer, the debt 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, no. 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 of the transferred assets at the date of the transfer.

62. Q—In certain transfers, the transferor retains an interest that should be subsequently accounted for under Issue 99-20. If the transferred asset was accounted for as available for sale under Statement 115 prior to the transfer, how should the transferor account for amounts in other comprehensive income at the date of transfer?

A—The application of Issue 99-20 should not result in recognition in earnings of an unrealized gain or loss that had been recognized in accumulated other comprehensive income before it is realized. The following example illustrates that concept.

An entity transfers financial assets that are appreciated debt securities to a qualifying SPE in exchange for 80 percent of the beneficial interests in the qualifying SPE and $30 in cash. The original cost basis for the debt securities is $100, and their 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 qualifying SPE also issues, for $30, beneficial interests entitled the unrelated investor to a fixed rate of interest for 5 years. On the fifth anniversary of the qualifying SPE, the assets remaining in it will be sold and the beneficial interest holders (the investor and the transferor) will receive the proceeds.

For purposes of applying Issue 99-20, the initial investment in the retained beneficial interests is the allocated carrying amount, that is, $120. Twenty percent or $10 of the unrealized gain of $50 would be recognized at the time of transfer. The remaining unrealized gain of $40 should remain in accumulated other comprehensive income until the qualifying SPE sells the assets remaining in the qualifying SPE. The amount of the unrealized gain in other comprehensive income ignores the effect of income taxes.

63. Q—Assume the same facts as in Question 62, except that the qualifying SPE is directed (at inception) to sell the transferred debt securities at a predetermined date and then to reinvest the proceeds in different debt instruments that mature at the same date that the qualifying SPE liquidates. When should the transferor recognize the unrealized gain of $40 that remained in accumulated other comprehensive income at the date of transfer?

A—The transferor should recognize a sale, and a gain or loss, when the transferred assets are sold...
by the qualifying SPE. At that point, the transferor's interest is no longer a beneficial interest in the
transferred assets but rather a beneficial interest in the different debt instruments. In the example
provided above, the $40 unrealized gain in accumulated other comprehensive income should be
recognized in the transferor's net income when the qualifying SPE sells the transferred assets.

64. 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 (or discount) 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 (or
accreted)?

A—Yes, but only to the extent a sale has not occurred because the transferor continues to hold
beneficial interests in the bond. ♦ Paragraph 10 of Statement 140 requires that, upon completion
of any transfer, a transferor (a) continue to carry in its statement of financial position any interest
it continues to hold in the transferred assets and (b) allocate the previous carrying amount between
the assets sold, if any, and the interests that continue to be held by the transferor, 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 (or accreted) 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. ♦ Issue 99-20 may also
apply in certain circumstances. [Revised 3/06.]

65. Q—In a transfer of financial assets in which the transferor continues to hold beneficial interests in
80 percent of the transferred assets, should the remaining 20 percent of transferred assets be
treated as sold, assuming that all the criteria in ♦ paragraph 9 of Statement 140 have been met?
[Revised 3/06.]

A—Yes. Paragraph 9 of Statement 140 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). [Revised 3/06.]

66. Q—Does the fair value measurement of an interest that continues to be held by the transferor in a
securitization that is classified as either available-for-sale or trading under Statement 115 include
the estimated cash flows associated with those 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)? [Revised 3/06.]

A—No. ♦ Paragraph 78 of Statement 140 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.” [Revised 3/06.]

67. 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 continue to hold 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, up to a
certain limit, 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 credit enhancement by continuing to hold 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 those subordinated interests, then the interests that continue to be held by the transferor should be initially recognized according to paragraph 10 of Statement 140 and should be subsequently measured like other interests that continue to be held by the transferor in the same form. Therefore, no recourse liability would be needed. [Revised 3/06.]

68. Q—What should the transferor consider when determining whether retained credit risk is a separate liability or part of a beneficial interest that continues to be held by the transferor? [Revised 3/06.]

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 only through the interest it continues to hold and a separate obligation should not be recognized. Credit losses from the underlying assets would affect the measurement of the interest that the transferor continues to hold. In contrast, if the transferor could be obligated for more than the cash flows provided by the interest it continues to hold 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. [Revised 3/06.]

69. Q—What is meant by the term practicable as used in paragraphs 11(c) and 71?

A—The Board did not define the term practicable in Statement 140. However, the Board explained its reasoning for the practicability exception. Paragraph 298 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 71 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.

70. Q—At what amount should the transferor initially recognize an asset obtained or a liability incurred for which, at the date of transfer, it was not practicable to estimate the fair value?

A—Paragraph 71 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 140 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 an estimate of fair value.

Paragraph 299 notes that the practicability exception does not extend to the transferee, since as “... the purchaser of the assets, [the transferee] should be able to value all assets and any liabilities it purchased or incurred, presumptively based on the purchase price paid.

Paragraph 71 of Statement 140 provides guidance on accounting for assets and liabilities in cases in which, 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? [Revised 3/06.]

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 140. ♦ Paragraph 13A of Statement 140 requires that if it is not practicable to initially measure a servicing asset or servicing liability at fair value, the transferor shall initially recognize the servicing asset or servicing liability in accordance with paragraph 71 of Statement 140 and shall include it in a class of servicing assets and servicing liabilities that is subsequently measured using the amortization method. ♦ Paragraphs 63(f) and 63(g) of Statement 140 require servicing assets and servicing liabilities subsequently measured using the amortization method to be evaluated for impairment or increased obligation. 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 140 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 140 only if it is a servicing liability. [Revised 3/06.]

The transferor would remeasure a servicing liability but not below the amortized measurement of its initially recognized amount. Paragraph 13A requires an entity that has elected to subsequently measure a class of separately recognized servicing assets and servicing liabilities using the amortization method to amortize servicing liabilities in proportion to and over the period of estimated net servicing loss, and assess servicing liabilities for increased obligation based on fair value at each reporting date. ♦ Paragraph 63(g) of Statement 140 requires:

For servicing liabilities subsequently measured using the amortization method, 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.

72. Q—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 70, ♦ paragraph 71 provides special requirements if it is not practicable to estimate the fair value of assets obtained or liabilities incurred.

73. Q—Does Statement 140 require disclosures about the assumptions used to estimate fair values of interests that continue to be held by a transferor in securitized financial assets or of assets obtained and liabilities incurred as proceeds in a transfer? [Revised 3/06.]

A—Yes. ♦ Paragraph 17(h)(3) of Statement 140 requires the disclosure of “the key assumptions used in measuring the fair value of interests that continue to be held by the transferor and servicing assets and servicing liabilities, if any, at the time of securitization . . .” (footnote omitted). Paragraph 17(i)(2) of Statement 140 requires disclosure of “the key assumptions used in subsequently measuring the fair value of those interests . . . ” held at the most recent balance sheet date. Finally, paragraph 17(i)(3) of Statement 140 requires a sensitivity analysis or stress test showing the hypothetical effect of changes in those assumptions on the fair value of those interests (including any servicing assets or servicing liabilities). [Revised 3/06.]

Paragraph 17(d) of Statement 140 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.” [Revised 3/06.]

74. 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 an interest that continues to be held by the transferor in transferred assets? [Revised 3/06.]

A—The proceeds that are placed in a cash reserve account are an interest that continues to be held by the transferor. ♦ Paragraph 58 of Statement 140 specifies that a cash reserve account is an interest that continues to be held by the transferor. 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 75–77. [Revised 3/06.]

75. Q—How should a transferor initially and subsequently measure the interest it continues to hold in credit enhancements provided in a transfer if the balance that is not needed to make up for credit
A—Some credit enhancements (for example, cash reserve accounts and subordinated beneficial interests) should be measured at the date of the transfer by allocating the previous carrying amount between the interests that the transferor continues to hold in the transferred assets and the assets sold, based on their relative fair values. Other credit enhancements (for example, financial guarantees and credit derivatives) are liabilities that are initially measured at their fair values. Question 68 discusses how to determine whether a credit enhancement is a new asset or an interest that continues to be held by the transferor. Questions 76 and 77 discuss techniques for estimating the fair value of an interest that continues to be held by the transferor. [Revised 3/06.]

Statement 140 does not specifically address the subsequent measurement of credit enhancements. How much cash the transferor will receive from, for example, a cash reserve account and when it will receive cash inflows depend 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 15(22) based on the nature of the credit enhancement.

76. Q—In certain securitization transactions, the transferor must provide a credit enhancement such as a cash reserve account or a subordinated beneficial interest. As discussed briefly in Question 74, 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 allocating the carrying amount based on relative fair value)?

A—Paragraphs 68–70 provide guidance on how to estimate fair value under Statement 140. Transferors are required to estimate fair value in a manner consistent with that guidance. 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 69 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” (footnote omitted).

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 asset 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, \textit{cash out}). Therefore, using an expected present value technique with a risk-free rate or a “best estimate” technique with an appropriate discount rate, the cash-out method estimates the fair value in a manner consistent with paragraph 69 (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, \textit{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. Thus a cash-in method is not appropriate.

77. Q—Paragraphs 69 and 70 of Statement 140 indicate that the Board believes that an expected present value technique is superior to traditional “best estimate” techniques in measuring the fair value of interests that continue to be held by the transferor in securitized assets. How might the expected present value technique be applied to such measurements? [Revised 3/06.]

A—Expected present value techniques are discussed and illustrated in general terms in FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements. Those techniques consider the likelihood of possible outcomes directly, rather than indirectly through the use of a risk-adjusted discount rate. The following illustration indicates one way in which those techniques might be applied in measuring the fair value, using a cash-out method, of an interest that continues to be held by the transferor in a securitization that was subordinated to investors’ interests through a “credit enhancement account,” a type of cash reserve account. [Revised 3/06.]

Illustration—Value of interest that continues to be held by the transferor in securitization of $1,000.00 of 15-year prepayable mortgages, in the form of a credit enhancement account that protects senior beneficial interests [Revised 3/06.]

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<th>Most Likely</th>
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**Total expected present value:**

**Notes:** Values derive from supporting scenario worksheets, one of which is shown on the following page.
Expected Cash Flow Illustration—Very Bad Scenario

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<th>Prepays</th>
<th>Interest</th>
<th>Total Cash In</th>
<th>Charge-offs</th>
<th>Investors' Share of: Interest</th>
<th>Prepays</th>
<th>Charge-offs</th>
<th>Due to Investors</th>
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<th>CF of</th>
<th>(Shortfall)</th>
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Explanation:

In this securitization, credit enhancement is provided to investors in senior beneficial interests using a credit enhancement account (CEA), sometimes called a "cash collateral account." Investors are entitled to cash payment of interest, their share of prepayments, and reimbursement for chargeoffs of uncollectable loans, to the extent that cash is available from the CEA.

Shortfalls in the CEA reimbursement are made up from future available cash inflows.

Remaining cash inflows are deposited in the credit enhancement account, until its balance exceeds the agreed targeted percentage of the remaining outstanding principal balance. Amounts in excess of the targeted balance may be withdrawn by the transferee.

Simplifications for purposes of illustration:

Here, the chargeoff and prepayment rates are assumed to be uniform over the life of the securitization, except for a larger chargeoff in year five. Under realistic assumptions, they would be lower.

The loans are non-amortizing, prepayable 15-year loans. Amortizing loans are more common in the United States.

While prepayments and chargeoffs are assumed to occur evenly throughout the year, CEA calculations are made only at the end of the year.

Only four scenarios are modeled (one of which is illustrated here). Realistic valuations would include more scenarios.

Servicing Assets and Servicing Liabilities

Adequate Compensation

Contract terms are:

Interest on loans
Interest due investors
Inveses share
Target credit enhancement
Est. chargeoffs (per yr
Est. prepayes (per yr

Superseded by the FASB Accounting Standards Codification on July 1, 2009.
Q—Paragraph 62 states that “typically, the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the servicing . . .” (emphasis added). What is meant by the term adequate compensation?

A—Paragraph 364 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.

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 71 for guidance. Refer to Question 80.

Q—Does the response to Question 79 mean that an entity is precluded from using a cash flow model to estimate adequate compensation?

A—No. As explained in paragraph 71, 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 79 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.

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 the initial measurement of the servicing asset? [Revised 3/06.]

A—Paragraphs 13 and 62 of Statement 140 require that a separately recognized servicing asset be initially measured at its fair value. The transferor should use the unsolicited bid from the third party as the basis for determining the fair value of servicing as it represents a quoted market price for its asset. Paragraph 68 of Statement 140 states that “if a quoted market price is available, the fair value is the product of the number of trading units times that market price” (emphasis added). [Revised 3/06.]

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. How should the fair value of servicing be determined? [Revised 3/06.]

A—As discussed in Question 81, paragraphs 13 and 62 of Statement 140 require that a separately recognized servicing asset be initially measured at its fair value. Quoted market price in active markets is the best evidence of fair value. If a quoted market price is not available, the estimate of fair value shall be based on the best information available in the circumstances. 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. [Revised 3/06.]

Paragraph 68 of Statement 140 states 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 objective for any estimate of fair value is to determine “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 68). 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 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
- Whether other parties have demonstrated interest in purchasing the servicing contract at a similar price.

[Revised 3/06.]

83. 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 62. 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 68–70 explain how to determine fair value under Statement 140. Paragraph 69 explains that an estimate of fair value shall be made only when a quoted market price is not available (refer to Questions 81 and 82). 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
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 68–70 explain how to determine fair value under Statement 140. Paragraph 69 explains that an estimate of fair value shall be made only when a quoted market price is not available (refer to Questions 81 and 82). 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 83.

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 364 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.

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 68). 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.

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

A—No. Paragraph 364 of Statement 140 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 140, 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 140. 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.

88. 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.

89. 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 364 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.

90. 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 140 include any requirement to adjust the recorded asset or liability?

A—Yes, in certain circumstances. Paragraphs 13A and 63 address the subsequent measurement of servicing assets and servicing liabilities. Under paragraphs 13A and 63, if an entity elects to subsequently measure a class of servicing assets and servicing liabilities using the fair value measurement method, changes in fair value are reported in earnings in the period in which the changes occur. If an entity elects to subsequently measure a class of servicing assets and servicing liabilities using the amortization method, each stratum within that class should be evaluated for impairment or increased obligation at each balance sheet date. If subsequent events increase the fair value of a stratum of servicing liabilities within a class that an entity has elected to subsequently measure using the amortization method, that increase must be recognized in earnings as a loss. [Revised 3/06.]

91. 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
A—Yes. ♦ Paragraph 78 states that “as new receivables are sold, rights to service them become assets or liabilities and are recognized.”

Contractually Specified Servicing Fees

92. [Question deleted 3/06 because FASB Statement No. 156, Accounting for Servicing of Financial Assets, provides specific guidance that addresses this question in its amendment to ♦ paragraph 13 of Statement 140.]

<table>
<thead>
<tr>
<th>Q—Paragraph 13 states:</th>
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<tr>
<td>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 transfers the assets to a qualifying SPE in a guaranteed mortgage securitization, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with [Statement 115].</td>
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In the latter circumstances, may an entity choose to recognize a servicing asset or liability?

A—Yes. ♦ Paragraphs 61 and 62 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 transfers the assets to a qualifying SPE in a guaranteed mortgage securitization, 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. That decision is a matter of accounting policy.

93. Q—How should an entity account for rights to future income from serviced assets that exceed contractually specified servicing fees?

A—♦ Paragraph 63 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 287 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.

94. 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 servicing liability is recorded is a function of the
marketplace, not the servicer’s cost of servicing. Paragraph 62 of Statement 140 explains:

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 a servicer for performing the servicing, the contract results in a servicing liability.

[Revised 3/06.]

Paragraph 364 of Statement 140 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 paragraphs 63(f) and 63(g) of Statement 140 for classes of servicing assets and servicing liabilities subsequently measured using the amortization method 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 140 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 140. [Revised 3/06.]

Servicing—Other

95. Q—Should an entity recognize a servicing liability if it transfers all or some of a financial asset (for example, a loan participation) and undertakes 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? [Revised 3/06.]

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 of Statement 140 states:

An entity shall recognize and initially measure at fair value, if practicable, a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations:

a. A transfer of the servicer's financial assets that meets the requirements for sale accounting
b. A transfer of the servicer's financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as either available-for-sale securities or trading securities in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates.

An entity that transfers its financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as debt securities held-to-maturity in accordance with Section I80 may either separately recognize its servicing assets or servicing liabilities or report those servicing assets or servicing liabilities together with the asset being serviced. [Revised 3/06.]

Those requirements apply even if it is not customary to charge a contractually specified servicing
fee. ♦ Paragraph 62 of Statement 140 states that “. . . if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability.” [Revised 3/06.]

96. Q—Assuming that (a) an entity transfers a portion of a loan under a participation agreement that qualifies for sale accounting under Statement 140, (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 62 of Statement 140). 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. [Revised 3/06.]

97. Q—An entity sells mortgage loans that it has originated and undertakes an obligation 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? [Revised 3/06.]

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 140—the obligation to service should be initially recognized and measured at fair value, if practicable, according to ♦ paragraphs 10 and 11 of Statement 140 as proceeds obtained from the transfer of the mortgage loans. Second, the entity should account for the subcontract with another servicer. The latter transaction is not within the scope of Statement 140 because it does not involve a transfer of the underlying mortgage loans and, therefore, should be accounted for under other existing guidance. [Revised 3/06.]

98. 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). 17(24) 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.

99. **Q**—Statement 140 requires that entities separately evaluate and measure impairment of designated strata of servicing assets within classes of servicing assets that are subsequently measured using the amortization method. Must those classes of servicing assets be stratified based on more than one predominant risk characteristic of the underlying financial assets if more than one characteristic exists? [Revised 3/06.]

**A**—No. ♦ Paragraph 13A of Statement 140 requires that an entity subsequently measure each class of servicing assets and servicing liabilities using either the amortization method or the fair value method. ♦ Paragraph 63(f)(1) of Statement 140 requires servicers to “stratify servicing assets within a class based on one or more of the predominant risk characteristics of the underlying financial assets” (emphasis added) for classes of servicing assets that a servicer elects to subsequently measure using the amortization method. Therefore, Statement 140 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). [Revised 3/06.]

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 63(f) of Statement 140 in a manner that would enable individual strata to comply with the requirements of Statement [133] regarding what constitutes ‘a portfolio of similar assets.”’ An entity may use different stratification criteria for the purposes of Statement 140 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. [Revised 3/06.]

100. **Q**—♦ Paragraph 63(f)(1) of Statement 140 requires a servicer to “stratify servicing assets within a class based on one or more of the predominant risk characteristics of the underlying financial assets” for classes of servicing assets that a servicer elects to subsequently measure using the amortization method. Should the strata selected by the servicer be used consistently from period to period? [Revised 3/06.]

**A**—Generally, yes. Once an entity has determined the predominant risk characteristics to be used in identifying the resulting strata within each class of servicing assets subsequently measured using the amortization method, 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 19–22 of FASB Statement No. 154, *Accounting Changes and Error Corrections*. 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(g)(4) of Statement 140. [Revised 3/05; 3/06.]

101. **Q**—Statement 140 requires impairment of servicing assets to be recognized “through a valuation allowance for an individual stratum” (♦ paragraph 63(f)(2); emphasis added) for classes of servicing assets that a servicer elects to subsequently measure using the amortization method. 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 63(f)(3)). How should an entity recognize subsequent increases in a previously recognized servicing liability? [Revised 3/06.]
Paragraph 63(g) of Statement 140 states that “for servicing liabilities subsequently measured using the amortization method, 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 relative to the cash flows previously projected, the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings.” 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. If an entity makes an election to subsequently measure a class of servicing liabilities using the fair value measurement method, any changes in fair value should be reported in earnings in the period in which those changes occur. [Revised 3/06.]

102. 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 71, 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).

103. Q—Should a valuation technique using undiscounted cash flows ever be used to estimate fair value of servicing liabilities?

A—No. A valuation technique that includes discounting should be used to estimate fair value. Using a valuation technique that does not consider the time value of money (discounting) would be inconsistent with the notion of fair value as described in ♦ paragraphs 68–70. Further, paragraph 69 explains that when measuring “servicing liabilities at fair value, the objective is to estimate the value of the assets required currently to (a) settle the liability with the holder or (b) transfer a liability to an entity of comparable credit standing.”

Financial Assets Subject to Prepayment

104. 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 in measuring 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 287, an interest-only strip does not depend on servicing being performed satisfactorily.

105. 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 interests that continue to be held by a transferor that meet 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 362 of Statement 140. [Revised 3/06.]

Interest-only strips and similar interests that continue to be held by a transferor 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. [Revised 3/06.]

106. 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.

107. Q—A transferor transfers mortgage loans to a third party but undertakes an obligation to service the loan. 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? [Revised 3/06.]

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 140.

♦ Paragraph 13 of Statement 140 states that:
An entity shall recognize and initially measure at fair value, if practicable, a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations:
   a. A transfer of the servicer's financial assets that meets the requirements for sale accounting
   b. A transfer of the servicer's financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as either available-for-sale securities or trading securities in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
   c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates.
   An entity that transfers its financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as debt securities held-to-maturity in accordance with Statement 115 may either separately recognize its servicing assets or servicing liabilities or report those servicing assets or servicing liabilities together with the asset being serviced.

The obligation to service should be initially recognized and measured at fair value, if practicable,
according to ◆ paragraphs 10 and 11 of Statement 140. Second, the entity should account for the contract with the subservicer. The latter transaction is not within the scope of Statement 140 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 97. [Revised 3/06.]

108. 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 enterprise has the positive intent and ability to hold those securities to maturity.” ◆ Paragraph 362 of Statement 140 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.”

109. 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 140?

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 paragraphs 6.48 and 6.49 of the May 1, 2000 AICPA Audit and Accounting Guide, 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.)

110. 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, ♦ Issue 99-20 provides guidance on how to apply the impairment provisions of Statement 115 to financial assets that are within the scope of Issue 99-20.

111. 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
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 295 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.”

112. 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.

If that note is within the scope of Statement 133, the guidance of paragraph 14 of Statement 140 would no longer apply because Statement 133 amended paragraph 19 of Statement 125 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 140.

113. 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 173 explains that “the effect of establishing the qualifying SPE is to merge the contractual rights in the transferred assets and to allocate undivided interests in them—the beneficial interests.” ♦ Paragraph 273 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.

[Revised 3/06.]

♦ Paragraph 295 states “... the rationale outlined in ♦ paragraph 293 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).
114. Q—Are the collateral accounting 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 accounting provisions of paragraph 15 apply to all transfers of financial assets pledged as collateral in a transaction accounted for as a secured borrowing. Accordingly, they apply to many repurchase agreement, dollar-roll, securities lending, and similar transactions in which cash is obtained in exchange for financial assets with an obligation for an opposite exchange later, as well as to many other transactions. However, as noted in footnote 4 to paragraph 15 and in paragraph 94, those collateral accounting provisions do not apply to cash, or securities that can be sold or pledged for cash, received as so-called “collateral” for noncash financial assets, for example, in certain securities lending transactions. Such cash or securities that can be sold or pledged for cash are accounted for as proceeds of either a sale or a borrowing.

115. 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 the transferee is permitted to sell or repledge those securities?

A—Paragraph 15 provides guidance on collateral accounting issues. Paragraph 15(a) indicates that pledged assets should be reclassified 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 95 illustrates possible classifications and terminology.

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

A—Statement 140 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 95 illustrates possible classifications and terminology.

117. Q—How should a transferor measure transferred collateral that must be reclassified (for example, as securities pledged to creditors)?

A—Paragraph 15(a) requires that transferred collateral that the secured party can, by contract or custom, sell or repledge 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 effectively 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 pledged to creditors 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 pledged to creditors should continue to be measured at amortized cost.

118. Q—Does Statement 140 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 140 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 5.93 of the AICPA Audit and Accounting 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

119. 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 311, an in-substance defeasance is different from a legal defeasance and the liability is not extinguished. A related issue is discussed in Question 35.

120. 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 Issues ♦ No. 96-19, “Debtor’s Accounting for a Modification or Exchange of Debt Instruments,” and ♦ No. 98-14, “Debtor’s Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements.”

121. 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 114, 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

122. Q—Does Statement 140 address impairment of financial assets?

A—As discussed in ♦ paragraph 4, Statement 140 “does not address subsequent measurement of assets and liabilities, except for (a) servicing assets and servicing liabilities and (b) interest-only strips, securities, interests that continue to be held by a transferor in securitizations, loans, other receivables, or other 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. . . .” 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
123. 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 otherwise liquidated 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 140?

A—Under Statement 140, 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. Refer to Question 49.
Endnotes

1 (Popup - Footnote *)
Q&A 140 Footnote *—At the date of issuance of this implementation guide, Halsey G. Bullen was a Senior Project Manager, Victoria A. Lusniak was an Assistant Project Manager and Stephen J. Young was a practice fellow at the FASB. The positions and opinions 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 140 Footnote 1—Whether or not that settlement is an extinguishment is governed by paragraph 16 of Statement 140.

3 (Popup - Footnote 2)
Q&A 140 Footnote 2—Although Statement 105 was superseded by FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, the Board’s definition of financial asset continues to be based on the definition of a financial instrument found in Statement 105.

4 (Popup - Footnote 3)
Q&A 140 Footnote 3—FASB Interpretation No. 46, Consolidation of Variable Interest Entities, should be applied, together with other guidance on consolidation policy, as appropriate, to determine whether such a special-purpose entity should be consolidated by a third-party investor. [Revised 4/03.]

5 (Popup - Footnote 4)
Q&A 140 Footnote 4—Refer to footnote 2.

6 (Popup - Footnote 4a)
Q&A 140 Footnote 4a—One exception is a transfer of an investment that is in substance real estate, as defined in FASB Interpretation No. 43, Real Estate Sales.

7 (Popup - Footnote 5)
Q&A 140 Footnote 5—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.

8 (Popup - Footnote 5a)
Q&A 140 Footnote 5a—See footnote 4a.

9 (Popup - Footnote 6)
Q&A 140 Footnote 6—Questions and answers 19A–19D are identical to Questions 1–4 respectively in Appendix B of Technical Bulletin 01-1. They are subject to the effective date provisions of that Technical Bulletin.

10 (Popup - Footnote *)
Q&A 140 Footnote *—Questions and answers 19A-19D are identical to Questions 1-4 respectively in Appendix B of Technical Bulletin 01-1. They are subject to the effective date provisions of that Technical Bulletin.

11 (Popup - Footnote *)
Q&A 140 Footnote *—Questions and answers 19A-19D are identical to Questions 1-4 respectively in Appendix B of Technical Bulletin 01-1. They are subject to the effective date provisions of that Technical Bulletin.

12 (Popup - Footnote 6a)
Q&A 140 Footnote 6a—A transferor's power to require the return of the assets arising solely from a contract with the transferee, for example, a call option or removal-of-accounts provision, would not
necessarily preclude a conclusion that transferred assets have been isolated from the transferor. However, under paragraph 9(c) of Statement 140, such a power might preclude sale treatment if through it the transferor maintains effective control over the transferred assets.

13 (Popup - Footnote *)
Q&A 140 Footnote * — Questions and answers 19A-19D are identical to Questions 1-4 respectively in Appendix B of Technical Bulletin 01-1. They are subject to the effective date provisions of that Technical Bulletin.

14 (Popup - Footnote 7)
Q&A 140 Footnote 7—The phrase consolidated affiliate of the transferor is defined in paragraph 364 of Statement 140 as “an entity whose assets and liabilities are included with those of the transferor in the consolidated, combined, or other financial statements being presented.”

15 (Popup - Footnote 8)
Q&A 140 Footnote 8—The transferor must still consider whether consolidation of the transferee is required under GAAP.

16 (Popup - Footnote 9)
Q&A 140 Footnote 9—Unless the transferor or its affiliates or agents is the servicer and, as servicer, is empowered to decide to put the assets up for sale. Refer to footnote 15 of Statement 140.

17 (Popup - Footnote 10)
Q&A 140 Footnote 10—The meanings of passive and pertain with respect to derivative financial instruments are discussed in paragraphs 39 and 40.

18 (Popup - Footnote 11)
Q&A 140 Footnote 11—If the dollar-roll repurchase agreement is accounted for as a sale under Statement 140, FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, provides guidance on the subsequent accounting for the forward contract.

19 (Popup - Footnote 12)
Q&A 140 Footnote 12—All call options discussed in this question are or can be physically settled. Cash-settled call “options” do not constrain the transferee, nor do they result in the transferor maintaining effective control because they do not provide the transferor with an opportunity to reclaim the transferred assets. (Certain cash-settled options may, however, be incompatible with the conditions that a qualifying SPE must meet.)

20 (Popup - Footnote 13)
Q&A 140 Footnote 13—Statement 140 provides three exceptions under which the ability to cause, unilaterally, the return of specific transferred assets does not maintain effective control: cleanup calls, calls at fair value with no residual interest, and conditional calls.

21 (Popup - Footnote 14)
Q&A 140 Footnote 14—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.

22 (Popup - Footnote 15)
Q&A 140 Footnote 15—Determining the appropriate literature for evaluating impairment is a matter of facts and circumstances. Other literature that might provide the appropriate guidance includes Statement 5, FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan, Statement 115, Statement 133, and Issue 99-20.

23 (Popup - Footnote 16)
Q&A 140 Footnote 16—The other amount is the estimate of the benefits of servicing.

24 (Popup - Footnote 17)

Q&A 140 Footnote 17—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.

25 (Popup - Footnote 18)

Q&A 140 Footnote 18—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.