On August 11, the FASB continued its repairs and maintenance project on FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, by issuing three exposure drafts:

- **Accounting for Transfers of Financial Assets** (a complete revision of the exposure draft that was initially released for public comment in June 2003);
- **Accounting for Servicing of Financial Assets**; and
- **Accounting for Certain Hybrid Financial Instruments** (also amends FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*).

The FASB is interested in your comments on the proposed amendments. The comment deadline is October 10, 2005.

The following discussion highlights some of the more significant changes proposed by the three amendments. Readers seeking additional details should consult the full text of the exposure drafts (200+ pages!), which can be found on the FASB’s Web site. Also, be forewarned that Statement 140 is technically complex; those not familiar with its requirements may find this discussion difficult reading.

**Transfers of Financial Assets**

**Legal Isolation — All Arrangements Must Be Considered**

Sale accounting can be achieved under Statement 140 only if the transferred assets have been isolated from the transferor and its consolidated affiliates. The proposed amendment tightens the isolation rule by requiring any isolation analysis to consider all arrangements or agreements made in connection with the transfer even if they
were not entered into at the time of the transfer, including those entered into subsequent to the transfer. Furthermore, if the transferee is a qualifying special-purpose entity (QSPE), no arrangement or agreement can be made between the transferor (or its consolidated affiliates or agents) and any holder of beneficial interests issued by that QSPE that would have caused the assets to fail the isolation criterion if the same arrangements or agreements had involved the QSPE instead of its beneficial interest holders. Isolation can be achieved only if the available evidence provides reasonable assurance that the transferred financial 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 that is not a bankruptcy-remote entity.

Transfers of Portions of Financial Assets

The proposed amendment makes it a bit more challenging to obtain sale treatment for transfers of portions of a financial asset. Sale treatment can be obtained for a transfer of a portion of a financial asset only if the entire original financial asset is first transferred to a QSPE, unless all interests in the original asset meet the definition of a participating interest.

The Accounting for Transfers of Financial Assets exposure draft defines a participating interest as having the following characteristics:

a. It represents an ownership interest in an individual financial asset other than an equity instrument, a derivative financial instrument, or a hybrid financial instrument with an embedded derivative that is not clearly and closely related as described in Statement 133.

b. All cash flows received from the asset are divided among the participating interests (including any interest retained by the transferor, its consolidated affiliates, or its agents) in proportion to the share of ownership represented by each, except for servicing fees representing adequate compensation and, if applicable, a share of the contractual interest representing all or a portion of the transferor's gain on sale received by the transferor as consideration related to the sale of the participating interest. The ownership shares remain constant over the life of the original financial asset.

c. Participating interest holders have no recourse to the transferor (or its consolidated affiliates or agents) or to each other, and no participating interest is subordinated to another. That is, no participating interest holder is entitled to receive cash before any other participating interest holder. The rights of each participating interest holder (including the transferor if it retains a participating interest) have the same priority, and that priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any participating interest holder.

d. Neither the transferor (or its consolidated affiliates, its agents, or a bankruptcy trustee or other receiver for the transferor, its consolidated affiliates, or its agents) nor any participating interest holder has the right to pledge or exchange the entire financial asset in which they own a participating interest.

Ability of the Transferee to Pledge or Exchange, and Application to Multiple-Step Structures

Under the proposed amendment, for a transfer of a financial asset, a group of financial assets, or a participating interest in an individual asset (collectively “financial assets”) to qualify as a sale, the transferee (or each holder of a beneficial interest if the transferee is a QSPE, including the transferor itself if it holds a beneficial interest) must have the right to pledge or exchange the assets (or beneficial interests) it receives, and no condition can both (1) constrain the transferee from taking advantage of its right to pledge or exchange and (2) provide more than a trivial benefit to the transferor. The exposure draft adds a requirement that in a transaction involving a series of steps designed to isolate the transferred financial assets (e.g., a “two-step” structure), each entity in the series that receives the transferred financial assets is considered a transferee and each transferee (or beneficial interest holder if the transferee is a QSPE) must be able to pledge or exchange those assets (or beneficial interests) without constraint.

Limitations on What a Qualifying Special Purpose Entity Can Hold

Prohibition of Equity Instruments

The exposure draft prohibits a QSPE from holding equity instruments unless the equity instruments are received as a result of efforts to collect its financial assets, and even then only temporarily. The FASB believes that holding equity instruments is inconsistent with the requirement that a QSPE can hold only financial assets that are passive in nature. Equity instrument should be interpreted broadly and includes equity securities as defined in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, as well as other forms of ownership interests in entities, such as partnership interests and investments in operating joint ventures.
**Notional Amount of Passive Derivatives Held by a QSPE**

The exposure draft allows a QSPE to hold passive derivative financial instruments that pertain to all beneficial interests issued by the QSPE, including those issued to the transferor, its affiliates, or its agents. The requirement to limit the notional amount of the derivative to the amount of beneficial interest held by third parties will be eliminated, since other proposed amendments generally will remove a transferor’s ability to circumvent the requirements of Statement 133 by using a QSPE.

**Rollovers of Beneficial Interests**

Certain SPEs finance long-term financial assets by issuing short-term beneficial interests. When the initial beneficial interests mature, new beneficial interests are issued to generate proceeds to pay off the original beneficial interests. This strategy is known as rolling over beneficial interests. A liquidity commitment, such as a letter of credit, is frequently provided to ensure that the obligations of the entity to redeem the maturing beneficial interests are met even if market or other factors disrupt the issuance of new beneficial interests. A liquidity commitment represents one type of involvement with a SPE; other types of involvements could include a credit quality enhancement, such as a guarantee of collectibility of the SPE’s assets, and other rights or obligations to specify the terms and conditions of the beneficial interests that the SPE issues, such as determining when and to whom to issue beneficial interests.

The exposure draft requires an evaluation of whether a combination of involvements with the SPE provides the holder of those involvements with an opportunity to obtain a more-than-trivial incremental benefit; i.e., whether the holder has the opportunity, “as a result of holding a combination of rights or obligations, to enhance its rights or minimize its obligations related to the...SPE in comparison to the opportunities associated with the same rights and obligations if each right and each obligation were held by separate, unrelated parties.” If any party, including parties not affiliated with the transferor, has the opportunity to obtain a more than trivial incremental benefit by having more than one type of involvement with the SPE, the SPE cannot be a QSPE. Whether a party has an opportunity to obtain a more-than-trivial incremental benefit from combinations of involvements requires consideration of the specific facts and circumstances. Beneficial interests issued by a revolving-period master trust are not considered rollovers if the proceeds are applied to reduce the transferor’s interest.

**Initial Measurement of a Transferor’s Beneficial Interest**

The exposure drafts eliminate the concept of transferors’ retained interests. The FASB reasoned that if an entire financial asset is transferred and the transferor has given up control of that asset, then any asset received in return is a new asset, even if the cash flows come from the asset originally held by the transferor. Accordingly, in a financial asset transfer that qualifies as a sale, all beneficial interests obtained by the transferor in the transaction (“transferor’s beneficial interests”) are initially recorded at fair value; they are no longer recorded at allocated carrying amount. Retained participating interests are the one exception to this general rule. The FASB concluded that the transferor has not surrendered control of participating interests that have not been sold to third parties. Since control has not been relinquished, participating interests retained by the transferor should be recorded at allocated carrying amount.

**Servicing Rights**

**Initially Measure at Fair Value**

The proposed amendment requires all separately recognized servicing rights to be initially recorded at fair value, regardless of whether such rights were purchased separately, assumed, or obtained in a sale or securitization transaction. This conclusion reflects the FASB’s belief that similar assets and liabilities that are newly obtained should be accounted for similarly, regardless of how they are obtained.

**Choice of Subsequent Measurement Methods**

The exposure draft permits entities to choose either of the following subsequent measurement methods for servicing rights:

- **Amortization Method** — The servicing asset or liability is amortized in proportion to and over the period of estimated net servicing income or loss. This is the method currently prescribed by Statement 140, and requires an assessment of servicing assets for impairment (or servicing liabilities for increased obligation) at each reporting date.
**Fair Value Method** — The servicing assets and liabilities are reported at fair value at each reporting date with changes in fair value recorded in earnings in the period in which they occur.

The election to subsequently measure servicing rights at fair value is irrevocable and should be made separately for each class of servicing assets and liabilities. The same measurement method should be applied to each servicing asset or liability within a class. A class of servicing assets or liabilities is determined based on the major asset type being serviced (for example, mortgage loans, credit card receivables, and automobile loans). The FASB considers the fair value measurement method to be preferable to the amortization method for purposes of justifying a subsequent change in accounting principle under FASB Statement No. 154, *Accounting Changes and Error Corrections*.

The ability to subsequently measure servicing assets at fair value may provide some relief to entities attempting to hedge the income statement volatility caused by fluctuations in the fair value of servicing rights. Statement 140 currently requires servicing rights to be carried at the lower of cost or market. In a rising interest rate environment, this can pose a challenge to entities attempting to offset economic changes in their servicing rights with a derivative, since decreases in the fair value of the derivative are reflected in the income statement but increases in the fair value of the servicing rights are not. Prior to the proposed amendment, the only way to avoid this volatility was to designate a derivative as a fair value hedge of the servicing rights and meet the stringent requirements for hedge accounting under Statement 133. Often this was difficult, since the effect of prepayment activity made it difficult to create an effective hedge.

**Disclosures**

Since the proposed amendments allow entities to choose between two different subsequent measurement methods for servicing rights, additional disclosure requirements are included in the exposure draft to facilitate comparisons between entities.

**Hybrid Financial Instruments**

**Scope**

This project will amend both Statement 140 and Statement 133.

**Exemption From Scope of Statement 133 Eliminated**

The proposed amendment will prospectively supersede Statement 133 Implementation Issue No. D1, “Application of Statement 133 to Beneficial Interests in Securitized Financial Assets.” A holder of a beneficial interest in securitized assets will need to evaluate that interest to determine if, under the provisions of Statement 133, it is a freestanding derivative or a hybrid financial instrument that contains an embedded derivative that may require bifurcation. That determination should be based on the contractual terms of the beneficial interest, including consideration of the payoff structure and payment priority. Concentration of credit risk in the form of subordination (e.g., subordinated beneficial interests) is not considered to be an embedded derivative under the exposure draft.

The exposure draft also allows a QSPE to hold a derivative financial instrument that pertains to a beneficial interest that is another derivative financial instrument. The prior restriction is no longer necessary due to the elimination of the exemption of beneficial interests in securitized assets from the requirements of Statement 133, previously provided by Implementation Issue D1.

**Fair Value Option**

The proposed amendment allows an entity, upon identifying a hybrid financial instrument that would be required to be separated into a host contract and a derivative instrument, to elect to remeasure that hybrid financial instrument in its entirety at fair value, with changes in fair value recognized in earnings. This irrevocable election must be made on an instrument-by-instrument basis upon initial recognition, and the hybrid instrument may not be subsequently designated as a hedging instrument pursuant to Statement 133. This election is not limited solely to beneficial interests in securitized financial assets. Use of the fair value option provides entities with relief from having to separately determine the fair value of an embedded derivative that requires bifurcation.
Effective Date and Transition of Proposed Amendments

Generally, all three proposed amendments would be effective at the earlier of (1) fiscal years beginning after December 15, 2005, or (2) fiscal years that begin during the quarter in which the final Statement is issued. SPEs that are qualifying under existing rules generally would have their qualifying status grandfathered under the new rules unless they receive additional assets or issue additional beneficial interests other than those they were previously committed to receive or issue as a result of commitments to parties other than the transferor. Refer to the Appendix for additional detail regarding the proposed effective dates for specific provisions of the amendments.
This table extracts from the exposure drafts the proposed effective dates for specific provisions of the proposed amendments.

<table>
<thead>
<tr>
<th>Provision</th>
<th>Effective Date</th>
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<tbody>
<tr>
<td>Transferred financial assets are isolated only if they would be beyond</td>
<td>Upon issuance of the final Statement (including transfers for which the transferor, its consolidated affiliates, or agents have any remaining commitments related to the transferred financial assets to deliver additional cash or other assets).</td>
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<td>the reach of the powers of a bankruptcy trustee or other receiver for the</td>
<td>Public Entities — Apply to transfers of financial assets occurring after the end of the first fiscal quarter beginning after issuance of the Statement.</td>
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<td>transferor or any of its consolidated affiliates that are not bankruptcy-remote entities</td>
<td>Nonpublic Entities — Apply to transfers of financial assets occurring in the first fiscal year beginning after the issuance of the Statement.</td>
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<td>Derecognition provisions</td>
<td>Public Entities — Apply to transfers of financial assets occurring after the end of the first fiscal quarter beginning after issuance of the Statement.</td>
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<tr>
<td>Measurement provisions for transferred and retained financial assets</td>
<td>Apply at the earlier of fiscal years beginning after December 15, 2005, or fiscal years beginning during the quarter in which the final Statement is issued.</td>
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<td>Effect of indirect agreements on the transferor’s ability to meet the</td>
<td>A formerly qualifying SPE that fails to meet this condition, but maintains its qualifying status under previous accounting standards, shall continue to be considered qualifying unless it receives additional assets or issues additional beneficial interests other than those it was previously committed to receive or issue as a result of commitments to parties other than the transferor.</td>
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<td>isolation requirement</td>
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<td>Permitted assets of QSPEs</td>
<td>A formerly qualifying SPE that fails to meet the conditions related to rollovers of beneficial interests, but maintains qualifying status under previous accounting standards, will continue to be considered qualifying until six months after the effective date of this Statement, or until it has rolled over a majority of the beneficial interests that were outstanding at the effective date of this Statement.</td>
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<tr>
<td>Rollovers of beneficial interests</td>
<td>A formerly qualifying SPE that fails to meet the conditions related to rollovers of beneficial interests, but maintains qualifying status under previous accounting standards, will continue to be considered qualifying until six months after the effective date of this Statement, or until it has rolled over a majority of the beneficial interests that were outstanding at the effective date of this Statement.</td>
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<tr>
<td>Isolation of Assets — No arrangement or agreement can be made between</td>
<td>A formerly qualifying SPE that fails to meet this condition, but maintains its qualifying status under previous accounting standards, shall continue to be considered qualifying unless it receives additional assets or issues additional beneficial interests other than those it was previously committed to receive or issue as a result of commitments to parties other than the transferor.</td>
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<td>any holder of beneficial interests issued by the QSPE and the transferor</td>
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<td>or its consolidated affiliates or agents that would have caused the assets</td>
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<td>Provision</td>
<td>Effective Date</td>
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<td>Hybrid financial instruments</td>
<td>Effective for all instruments obtained or issued after the beginning of the earlier of an entity's first fiscal year beginning after December 15, 2005, or the entity's fiscal year that begins during the fiscal quarter in which the Statement is issued. Provisions of the Statement shall not be applied to instruments that an entity holds at the effective date.</td>
</tr>
<tr>
<td>Initial measurement of separately recognized servicing rights at fair value</td>
<td>Apply prospectively for transactions occurring in the earlier of the first fiscal year that begins after December 15, 2005, or fiscal years beginning during the fiscal quarter in which the Statement is issued.</td>
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<tr>
<td>Subsequent measurement of servicing rights at fair value upon adoption of the Statement</td>
<td>An irrevocable decision to subsequently measure a class of separately recognized servicing rights at fair value may be applied as of the earlier of the beginning of the first fiscal year that begins after December 15, 2005, or the beginning of fiscal years beginning during the fiscal quarter in which the Statement is issued. The subsequent measurement of servicing rights at fair value shall be applied prospectively with a cumulative-effect adjustment to beginning retained earnings to reflect the difference between the fair value and the carrying amount of the servicing rights that exist at the date of the entity's election.</td>
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<tr>
<td>Subsequent measurement of servicing rights at fair value after adoption of the Statement</td>
<td>An entity may apply an irrevocable decision to subsequently measure an existing class of separately recognized servicing rights at fair value as of the beginning of any fiscal year that begins subsequent to the adoption of the Statement. The subsequent measurement of servicing rights at fair value shall be applied prospectively with a cumulative-effect adjustment to beginning retained earnings to reflect the difference between the fair value and the carrying amount of the servicing rights that exist at the date of the entity's election.</td>
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<tr>
<td>Subsequent measurement of servicing rights at fair value for a new class of servicing rights</td>
<td>If after the date of initial adoption of the Statement, an entity recognizes servicing rights of a class of assets for which no such servicing rights had been previously recognized by the entity, that entity may elect to subsequently measure that new class of servicing rights at fair value at the date of initial recognition of that class of servicing rights.</td>
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