

the registrant to infuse cash into NEWCO under certain circumstances.

The staff also believes that even where the registrant receives solely cash proceeds, the recognition of any gain would be impacted by the existence of any guarantees or other agreements that may require the registrant to infuse cash into NEWCO, particularly when the first two factors listed above exist.

Question 2: If immediate recognition of all or a portion of the apparent gain is not appropriate due to the existence of facts and circumstances similar to the above, at what future date should the gain be recognized and how should the deferred gain be disclosed in the financial statements?

Interpretive Response: Generally, the staff believes that the deferred gain⁴ should not be recognized until such time as cash flows from operating activities are sufficient to fund debt service and dividend requirements (on a full accrual basis)⁵ or the registrant's investment in NEWCO has been or could be readily converted to cash (e.g., active trading market develops in NEWCO securities and the registrant is not restricted from selling such securities, the registrant sells the securities received on a nonrecourse basis, etc.) and the registrant has no further obligations under any debt guarantees or other agreements that would require it to make additional investments in NEWCO.

The staff believes that the amount of any deferred gain (including deferral of interest or dividend income on securities received) should be disclosed on the face of the balance sheet as a deduction from the related asset account (i.e., investment in NEWCO). The footnotes to the financial statements should include a complete description of the transaction, including the existence of any commitments and contingencies, the terms of the securities received, and the accounting treatment of amounts due thereon.

V. Certain Transfers of Nonperforming Assets

Facts: A financial institution desires to reduce its nonaccrual or reduced rate loans and other nonearning assets, including foreclosed real estate (collectively, "nonperforming assets"). Some or all of such nonperforming assets are transferred to a newly-formed

entity (the "new entity"). The financial institution, as consideration for transferring the nonperforming assets, may receive (a) the cash proceeds of debt issued by the new entity to third parties, (b) a note or other redeemable instrument issued by the new entity, or (c) a combination of (a) and (b). The residual equity interests in the new entity, which carry voting rights, initially owned by the financial institution, are transferred to outsiders (for example, via distribution to the financial institution's shareholders or sale or contribution to an unrelated third party).

The financial institution typically will manage the assets for a fee, providing necessary services to liquidate the assets, but otherwise does not have the right to appoint directors or legally control the operations of the new entity.

Statement 140 provides guidance for determining when a transfer of financial assets can be recognized as a sale. The interpretive guidance provided in response to Questions 1 and 2 of this SAB does not apply to transfers of financial assets falling within the scope of Statement 140. Because Statement 140 does not apply to distributions of financial assets to shareholders or a contribution of such assets to unrelated third parties, the interpretive guidance provided in response to Questions 1 and 2 of this SAB would apply to such conveyances.

Further, registrants should consider the guidance contained in FASB Interpretation 46 in determining whether it should consolidate the newly-formed entity.

Question 1: What factors should be considered in determining whether such transfer of nonperforming assets can be accounted for as a disposition by the financial institution?

Interpretive Response: The staff believes that determining whether nonperforming assets have been disposed of in substance requires an assessment as to whether the risks and rewards of ownership have been transferred. SAB Topic 5.E¹ discusses some factors that the staff believes should be considered in determining whether the risks of a business have been transferred. Consistent with the factors discussed in SAB Topic 5.E, the staff believes that the transfer described should not be accounted for as a sale or disposition if (a) the transfer of nonperforming assets to the new entity provides for recourse by the new entity

to the transferor financial institution, (b) the financial institution directly or indirectly guarantees debt of the new entity in whole or in part, (c) the financial institution retains a participation in the rewards of ownership of the transferred assets, for example through a higher than normal incentive or other management fee arrangement,² or (d) the fair value of any material non-cash consideration received by the financial institution (for example, a note or other redeemable instrument) cannot be reasonably estimated. Additionally, the staff believes that the accounting for the transfer as a sale or disposition generally is not appropriate where the financial institution retains rewards of ownership through the holding of significant residual equity interests or where third party holders of such interests do not have a significant amount of capital at risk.

Where accounting for the transfer as a sale or disposition is not appropriate, the nonperforming assets should remain on the financial institution's balance sheet and should continue to be disclosed as nonaccrual, past due, restructured or foreclosed, as appropriate, and the debt of the new entity should be recorded by the financial institution.

Question 2: If the transaction is accounted for as a sale to an unconsolidated party, at what value should the transfer be recorded by the financial institution?

Interpretive Response: The staff believes that the transfer should be recorded by the financial institution at the fair value of assets transferred (or, if more clearly evident, the fair value of assets received) and a loss recognized by the financial institution for any excess of the net carrying value³ over the fair value.⁴ Fair value is the amount that

² The staff recognizes that the determination of whether the financial institution retains a participation in the rewards of ownership will require an analysis of the facts and circumstances of each individual transaction. Generally, the staff believes that, in order to conclude that the financial institution has disposed of the assets in substance, the management fee arrangement should not enable the financial institution to participate to any significant extent in the potential increases in cash flows or value of the assets, and the terms of the arrangement, including provisions for discontinuance of services, must be substantially similar to management arrangements with third parties.

³ The carrying value should be reduced by any allocable allowance for credit losses or other valuation allowances. The staff believes that the loss recognized for the excess of the net carrying value over the fair value should be considered a credit loss and this should not be included by the financial institution as loss on disposition.

⁴ The staff notes that the EITF reached a consensus at its November 17, 1988 meeting on

⁴ In situations in which the gain is deferred following the guidance in this SAB, the staff believes that the seller generally should not recognize any income from the securities received in such transactions (including accretion of securities to their face or redemption value) until realization is more fully assured.

⁵ See note 4.

¹ SAB Topic 5.E addresses the accounting for the transfer of certain operations whereby there is a continuing involvement by the seller or other evidence that incidents of ownership remain with the seller.