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Proposed statement of position : definition substantially the same for holders of debt instruments;Definition substantially the same for holders of debt instruments

American Institute of Certified Public Accountants. Accounting Standards Division

American Institute of Certified Public Accountants. Committee on Banking

American Institute of Certified Public Accountants. Savings and Loan Associations Committee

American Institute of Certified Public Accountants. Stockbrokerage and Investment Banking Committee

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

DEFINITION OF *SUBSTANTIALLY THE SAME* FOR HOLDERS OF DEBT INSTRUMENTS

APRIL 29, 1988

Prepared by the
Committee on Banking,
Savings and Loan Associations Committee, and
Stockbrokerage and Investment Banking Committee
American Institute of Certified Public Accountants

Comments should be received by July 29, 1988, and addressed to
Myrna H. Parker, Technical Manager, Federal Government Relations Division, File B-1-403
AICPA, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1007

SUMMARY

This proposed statement of position provides guidance for determining whether two debt instruments have the characteristic termed <u>substantially the same</u> in the Bank Audit Guide.

The AICPA's Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee conclude the following:

> For debt instruments, including mortgage-backed securities, to be <u>substantially the same</u>, <u>all</u> the following criteria must be met:
>
> a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, or agency thereof, in which case the guarantor must be the same.
>
> b. The debt instruments must be identical in form and type.
>
> c. The debt instruments must bear the identical contractual interest rate.
>
> d. The debt instruments must have the same maturity except in the case of mortgage-backed pass-through securities for which the mortgages collateralizing the securities must be similar with respect to maturities (that is, expected remaining lives) resulting in approximately the same market yield.
>
> e. In the case of mortgage-backed pass-through securities, the securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
>
> f. The debt instruments must have the same aggregate unpaid principal amounts, except in the case of mortgage-backed pass-through securities, the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted "good delivery" standard for the type of mortgage-backed security involved. (This criterion amends paragraph 25 of SOP 85-2 in that the paragraph no longer specifies that "good delivery" occurs if the breakage is within 2.5 percent [plus or minus].)

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April 29, 1988

Accompanying this letter is an exposure draft of a proposed statement of position (SOP), Definition of Substantially the Same for Holders of Debt Instruments. A summary of the proposed SOP also accompanies this letter.

Under this proposed statement of position, for example, the exchange of a "fast-pay" GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a "slow-pay" GNMA certificate would not be considered an exchange of certificates termed substantially the same. Differences in the expected remaining lives of the certificates result in different market yields and thus, the certificates would not meet the proposed criteria. The exchange of a GNMA I certificate for a GNMA II certificate would not be considered the exchange of substantially the same certificates, as well. Under the GNMA I program, the certificate has the same coupon rate as the mortgages collateralizing the security. However, under the GNMA II program, the coupon rate of the certificate may vary from the rates of the underlying mortgage loans. Thus, GNMA Is vary "in form and type" from GNMA IIs and would not meet the proposed criteria. Similarly, the exchange of loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits would not be considered the exchange of substantially the same loans. Differences in the tax receipts associated with the loans result in instruments that vary "in form and type," and thus would not meet the proposed criteria.

Comments or suggestions on any aspect of this exposure draft will be appreciated. Respondents on the proposed SOP are specifically requested to provide comments on exchanges of debt instruments that are presently considered exchanges of substantially the same instruments but that would not be considered substantially the same under the proposed criteria. Respondents are also asked to comment specifically on whether the term market yield as used in paragraph 12 (d) is a more accurate and understood term than the term market price, and, if not, whether market price would be a better term to use. Responses will be most helpful if they refer to the specific paragraph numbers and include reasons for any suggestions or comments.

Comments on this exposure draft should be sent to Myrna H. Parker, Technical Manager, Federal Government Relations Division, File B-1-403, AICPA, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1007, in time to be received by July 29, 1988.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the Washington office of the American Institute of Certified Public Accountants after August 29, 1988, for one year.

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PROPOSED STATEMENT OF POSITION
DEFINITION OF SUBSTANTIALLY THE SAME
FOR HOLDERS OF DEBT INSTRUMENTS

SCOPE

1. This proposed statement of position provides guidance for determining whether two debt instruments that are exchanged are substantially the same. The conclusions presented in this proposed statement of position are not intended to modify, in any way, Statement of Financial Accounting Standards (SFAS) No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings. Paragraph 42 of SFAS No. 15 discusses certain situations where a troubled debt restructuring may involve substituting debt of another business enterprise, individual, or governmental unit for that of the troubled debtor. The accounting principles set forth in paragraph 42 of SFAS No. 15 are not affected by the guidance provided in this proposed statement of position.

2. The recommendations in this proposed statement of position are limited to transactions involving holders of debt instruments as assets. The term debt instruments is used broadly in this proposed statement of position to include instruments usually considered to be securities (such as notes, bonds, and debentures) as well as other evidence of indebtedness (such as money market instruments, certificates of deposit, mortgages, commercial loans, and commercial paper) that often are not referred to as securities.

3. The recommendations in this proposed statement of position amend the AICPA Industry Audit Guides, Audits of Banks (Bank Audit Guide), and Audits of Brokers and Dealers in Securities (Broker/Dealer Guide). This proposed statement of position also amends Statement of Position (SOP) 85-2, Accounting for Dollar Repurchase-Dollar Reverse Repurchase Agreements by Sellers-Borrowers.

BACKGROUND

4. The preface of the Bank Audit Guide states that certain issues affecting the banking industry are not included in the guide or are under study by the AICPA or the Financial Accounting Standards Board (FASB). One of those issues relates to the definition of the term substantially the same as used in the guide.

5. On page 33 of the Bank Audit Guide, the term substantially the same is used in describing wash sales as follows:

> Bank supervisory agencies currently prescribe that investment security gains and losses be recognized according to the completed transaction method. In practice, serious questions develop about the proper definition of "completed transactions" when securities are sold with the intent to reacquire the same or substantially the same securities, most often to obtain income tax or other benefits.

In such transactions, known as "wash sales," the period of time between sale and reacquisition varies. It is often very short, especially when readily marketable securities are involved. In some cases, the security or evidence of ownership of the security remains in the possession of the seller or his agent; only brokers' advices provide evidence of the sale and reacquisition.

In a sale, the risks and opportunities of ownership are transferred for a reasonable period of time; such a transfer is necessary to constitute realization and permit recognition of revenue. Therefore, when a bank sells a security and concurrently reinvests the proceeds from the sale in the same or substantially the same security, no sale should be recognized, since the effect of the sale and repurchase transaction leaves the bank in essentially the same position as before, notwithstanding the fact that the bank has incurred brokerage fees and taxes. When the proceeds are not reinvested immediately, but soon thereafter, the test is whether the bank was at risk for a reasonable period of time to warrant the recognition of a sale. The period of time cannot be defined exactly; rather, the type of securities involved and the circumstances of the particular transaction should enter into the determination of what constitutes a reasonable period of time. For example, a day may be appropriate for a quoted stock or bond that has a history of significant market price fluctuations over short periods of time. Similarly, a bank's liquidity requirements may require that a long-term bond be replaced by a short-term money market instrument; but a week later, the bank's liquidity requirements may change, and reacquisition of the bond previously sold may be a reasonable business decision, wholly independent of the previous decision to sell the bond. [Emphasis added.]

6. The terms substantially the same, substantially similar, and substantially identical are also used to describe a factor that is considered in determining whether a sale of a debt instrument under an agreement to repurchase should be accounted for as a sale and a purchase or as a financing transaction. For example, the terms substantially similar and substantially identical are used in SOP 85-2. Dollar repurchase-dollar reverse repurchase agreements involve similar but not identical securities. The terms of the agreements often provide data to determine whether the securities are similar enough to make the transaction in substance a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities.

7. A dollar repurchase-dollar reverse repurchase agreement is an agreement (contract) to sell and repurchase or to purchase and sell back securities of the same issuer but not the original securities. Fixed coupon and yield maintenance dollar agreements comprise the most common agreement variations. In a fixed coupon agreement, the seller and buyer agree that delivery will be made with securities having the same stated interest rate as the interest rate stated on the securities sold. In a yield maintenance agreement, the parties agree that delivery will be made with securities that will provide the seller a yield that is specified in the agreement.

8. Paragraph 29 of SOP 85-2 states:

> The Accounting Standards Division believes that yield maintenance agreements do not involve substantially similar securities. Fixed coupon agreements do involve substantially identical securities for purposes of this statement. [Emphasis added. Footnote reference omitted.]

9. The term substantially identical is also used by brokers and dealers when discussing repurchase transactions. The AICPA Audit and Accounting Guide, Audits of Brokers and Dealers in Securities, states on page 10:

> A repurchase transaction, commonly known as a repo transaction, is a sale of a security coupled with an agreement by the seller to repurchase the same or substantially identical security at a stated price. . . . A reverse repurchase agreement, known as a reverse repo, is the purchase of a security at a specified price with an agreement to resell the same or substantially identical security at a definite price at a specific future date. [Emphasis added.]

The Broker/Dealer Guide does not provide any guidance for determining whether the securities are substantially identical.

10. Because of the lack of an authoritative definition of substantially the same, alternative accounting practices have developed or may develop for the exchange of substantially the same assets.

PRESENT ACCOUNTING PRACTICES

11. The issue of whether two debt instruments are substantially the same generally arises in connection with determining whether a transaction involving debt instruments results in a sale or a financing, for example, the sale of a debt instrument under an agreement to repurchase another debt instrument. If the debt instrument to be repurchased is substantially the same as a debt instrument sold, it is often viewed as a financing transaction. On the other hand, if the debt instrument to be repurchased is viewed as not being substantially the same, the transaction is generally recorded as a sale with a commitment to purchase another debt instrument.

12. Two debt instruments can differ in a variety of ways, such as the obligor, maturity, interest rate, yield, and the like. If two debt instruments are exchanged and many of the characteristics of the instruments are different (for example, exchange of a U.S. Treasury bill for a mortgage-backed security), virtually all would agree that a transaction has taken place that requires accounting recognition as a sale, not a financing. On the other hand, if two debt instruments are exchanged and most of the characteristics of the instruments are the same, many would view the exchange as involving substantially the same securities prohibiting accounting recognition (for example, the exchange of two GNMA securities bearing the identical contractual interest rate that are collateralized by similar pools of mortgages resulting in approximately the same yield). Thus, the issue to resolve is how similar the characteristics of two debt instruments have to be before they can be viewed as substantially the same.

CONCLUSIONS

13. In order to minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of substantially the same should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:

a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, or agency thereof, in which case the guarantor must be the same.

b. The debt instruments must be identical in form and type.*

c. The debt instruments must bear the identical contractual interest rate.

d. The debt instruments must have the same maturity except in the case of mortgage-backed pass-through securities for which the mortgages collateralizing the securities must be similar with respect to maturities (that is, expected remaining lives) resulting in approximately the same market yield.

e. In the case of mortgage-backed pass-through securities, the securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.

f. The debt instruments must have the same aggregate unpaid principal amounts, except in the case of mortgage-backed pass-through securities, the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted "good delivery" standard for the type of mortgage-backed security involved. (This criterion amends paragraph 25 of SOP 85-2 in that the paragraph no longer specifies that "good delivery" occurs if the breakage is within 2.5 percent [plus or minus].)

EFFECTIVE DATE AND TRANSITION

14. The conclusions in this proposed statement of position should be applied prospectively to transactions entered into after December 15, 1988. Earlier application is encouraged.

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*For example, the exchange of GNMA I securities for GNMA II securities would not meet this criterion. Similarly, the exchange of loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits would not meet this criterion.