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FTB 85-1 Status Page

Accounting for the Receipt of Federal Home Loan Mortgage Corporation Participating Preferred Stock

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Financial Accounting Standards Board
of the Financial Accounting Foundation
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FTB 85-1: Accounting for the Receipt of Federal Home Loan Mortgage Corporation Participating Preferred Stock

References:

ARB No. 43, Chapter 7, "Capital Accounts," Section B, "Stock Dividends and Stock Split-ups," paragraph 1
APB Opinion No. 29, *Accounting for Nonmonetary Transactions,* paragraphs 18, 23, 25, and 26
APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, paragraph 20
FASB Statement No. 12, *Accounting for Certain Marketable Securities*
FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, paragraph 20

Question

1. On December 6, 1984, the Federal Home Loan Mortgage Corporation (FHLMC) created a new class of participating preferred stock (preferred stock) and distributed the preferred stock to the 12 district banks of the Federal Home Loan Banking System subject to the condition that the district banks subsequently distribute the stock to their member institutions (primarily savings and loan institutions) that owned stock in the district banks as of December 31, 1984. Until that time, the FHLMC had one class of capital stock outstanding that was callable at par and was owned by the 12 district banks. How should the members of the Federal Home Loan Banking System account for the receipt of the preferred stock?

Response

2. The distribution of preferred stock grants the member institutions an ownership right to the residual net assets of the FHLMC that they did not have previously, directly or indirectly, since the only previously outstanding capital stock was redeemable at par. The preferred stock is a nonmonetary asset that should be recognized by member institutions at its fair value as of December 31, 1984, in accordance with Opinion 29 (as discussed in paragraph 12 below). The resulting income should be reported as an extraordinary item in accordance with Opinion 30.

3. The fair value of the preferred stock recognized as of December 31, 1984 becomes its cost. Since the stock is trading on the New York Stock Exchange, it is a marketable equity security that subsequently should be reported in accordance with Statement 12 (at the lower of cost or market).

4. The FHLMC resolution authorizing the distribution of the preferred stock requires that the preferred stock be distributed to the member institutions as a condition of the district banks' receipt of the stock. Because the district banks did not have the benefits of ownership of the preferred stock at any time, for financial reporting purposes the preferred stock was not an asset to them, and they should not report the receipt of the preferred stock as income or their distribution of the preferred stock as a dividend.

Effective Date and Transition

5. The provisions of this Technical Bulletin are effective for financial statements issued after March 31, 1985 for fiscal years ending after December 1, 1984, and for interim periods within such years. Earlier application is encouraged. If financial statements have been issued that did not report this transaction in December 1984 as required herein, those financial statements should be restated to conform to the provisions of this Technical Bulletin when subsequently

Appendix:

BACKGROUND

6. On December 6, 1984, the board of directors of the FHLMC adopted resolutions establishing a new class of participating preferred stock to be distributed through the district banks to the member institutions. Prior to the creation of the preferred stock, the only outstanding capital stock of the FHLMC was $100,000,000 of $1,000 par, nonvoting, redeemable common stock held by the district banks. The district banks' only capital stock is $100 par redeemable common stock held by the member institutions.

7. The accounting by the member institutions for the preferred stock received has been the subject of some controversy. The Federal Home Loan Bank Board (FHLBB), as the governing body of the Federal Home Loan Bank System, requested an analysis of the transaction from several accounting firms in December 1984. The consensus of those firms was that the member institutions should record the preferred stock at its fair value based on an investment advisor's appraisal, resulting in income in 1984.

8. The FASB was asked by several interested parties to indicate its views on the accounting issues. On January 17 and 18, 1985, the FASB met jointly in public Board meetings with representatives of its Emerging Issues Task Force, the FHLBB, the FHLMC, and others to gather information regarding the transfer of preferred stock. A proposed Technical Bulletin, *Accounting for the Receipt of Federal Home Loan Mortgage Corporation Participating Preferred Stock*, was released for comment for 15 days on January 25, 1985, and 254 comment letters were received. Virtually all respondents agreed with the proposed Technical Bulletin as released for comment.

9. The threshold accounting issue is whether something of value has been received by the member institutions to which they previously were not entitled. One possibility was that the issuance of the preferred stock was simply a recognition of implicit existing ownership rights of member institutions. If so, it would follow that ARB 43, Chapter 7B provides relevant accounting guidance for this transaction. Although ARB 43, Chapter 7B does not apply to stock dividends of shares of a different class, the underlying concept would seem to apply if no new ownership rights were transferred. The following description of a stock dividend from ARB 43, Chapter 7B would seem to parallel this distribution:

> 1. The term *stock dividend* as used in this section refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property which the board of directors deems necessary or desirable to retain in the business.

10. Another possibility was that the interrelationships among the FHLBB, the district banks, and the member institutions with regard to this transaction were such that the spinoff provisions of paragraph 23 of Opinion 29 should be applied. Under that approach, the member institutions would allocate the cost of district bank stock owned between the FHLMC stock received and the district bank stock and would not report income from receipt of the FHLMC stock.

11. Representatives of the FHLBB and the FHLMC have indicated that the distribution of preferred shares granted the member institutions additional legal rights to the net assets of the FHLMC that were not previously held by them. It follows that something of value was received by the member institutions to which they previously had no rights, somewhat like a grant from government.

12. Because something of value was transferred to the member institutions to which they previously had no rights, either directly or indirectly, the member institutions should recognize the fair value of the preferred stock under Opinion 29 if that fair value is determinable within reasonable limits. That Opinion establishes the following basic principle in paragraph 18:

> . . . a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received.

That basic principle is modified, however, if fair value is not determinable within reasonable limits. Paragraphs 25 and 26 of Opinion 29 discuss the determination of fair values:

> 25. Fair value of a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction should be determined by referring to estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence.
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> 26. Fair value should be regarded as not determinable within reasonable limits if major uncertainties exist about the realizability of the value that would be assigned to an asset received in a nonmonetary transaction accounted for at fair value.

The FHLMC obtained an independent appraisal from an investment banker of the price range at which the preferred stock could be expected to trade. Trading began on the New York Stock Exchange on January 23, 1985.

13. Some believe that the member institutions should report the receipt of preferred stock as a dividend from the district banks and that it is not extraordinary since dividends have been periodically declared by the district banks. Others, relying on the two requirements for an extraordinary item in paragraph 20 of Opinion 30, believe that the receipt of the preferred stock is an extraordinary item because of its nature:

> a. *Unusual nature*—the underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.
> b. *Infrequency of occurrence*—the underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

The conclusion in paragraph 2 of this Technical Bulletin that the member institutions should report the distribution as an extraordinary item is based on two factors. First, the substance of the distribution is not a dividend in the usual sense from the district banks since they were merely a conduit for the distribution (as more fully discussed in paragraph 14). Second, the distribution recognizable by the member institutions represents a distribution of residual rights not previously held, either directly or indirectly, by the member institutions. Those residual rights can be distributed only *once*, and therefore the distribution is both unusual and cannot be expected to recur.

14. Some have evaluated the distribution of the preferred stock as the receipt of a dividend-in-kind by the district banks and then a dividend-in-kind by those banks to their member institutions that should be recognized by the district banks at its fair value. Two questions are involved in determining the accounting by the district banks: first, whether the receipt of the preferred stock by the district banks constitutes an asset and therefore income to them and, second, if so, at what amount the asset should be recognized by the district banks. In response to the first question, the stock must first have been an asset of the district banks for them to distribute it as a dividend-in-kind. Concepts Statement 3 is relevant in identifying whether the stock had the essential characteristics of an asset to the district banks. Paragraph 20 states:

> An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular enterprise can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the enterprise's right to or control of the benefit has already occurred.

The district banks' receipt of the preferred stock was contingent upon its subsequent distribution, so the district banks did not have control of the stock and could not obtain benefit from it. Accordingly, the preferred stock was not an asset or income to the district banks. It was a transfer of a residual interest in the FHLMC through the district banks rather than a dividend from them to the member institutions. While the transaction demonstrates the limited rights of the district banks in the FHLMC and warrants disclosure of the newly defined relationship, it does not constitute a transaction that should affect income or equity of the district banks. In response to the second question, the preferred stock, while having a value to the member institutions, had no realizable value to the district banks as is required by paragraph 23 of Opinion 29 for value to be recognized by the district banks.

15. This Technical Bulletin does not address the accounting for the distribution of preferred stock by the FHLMC. The substance of this distribution is unique and the authoritative accounting literature does not appear to be specifically applicable. Further, the issues are limited to a single transaction by a single entity.

The Financial Accounting Standards Board has authorized its staff to prepare FASB Technical Bulletins to provide guidance on certain financial accounting and reporting problems on a timely basis, pursuant to the procedures described in FASB Technical Bulletin No. 79-1 (Revised), *Purpose and Scope of FASB Technical Bulletins and Procedures for Issuance*. The provisions of Technical Bulletins need not be applied to immaterial items.