

Case 04-8

DrugKing

This case study involves determining the effects of call options and put options on the accounting for transfers of financial assets under ASC 860, *Transfers and Servicing: Overall*, as amended by ASU 2009-16, *Accounting for Transfers of Financial Assets* (FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (Statement 140)*, as amended by FASB Statement No. 166). The specific topics, highlighted in the examples below, include (1) attached call options on specific assets and freestanding call options on specific assets readily obtainable elsewhere, (2) conditional call options on transferred assets, and (3) in-the-money put options on transferred assets.

Note: For all examples below, the presumption exists that the respective call option provides the transferor of the financial assets with a more-than-trivial benefit.

Example 1

DrugKing transfers two financial assets, its investments in the Series A and Series B preferred stock of Tip-Top, to InsureAll, a substantive third party. The Series A preferred stock are traded publicly (i.e., they are readily obtainable in the marketplace). The Series B preferred stock is not traded publicly as the entire series was held by DrugKing prior to its transfer to InsureAll (i.e. not readily obtainable in the marketplace).

DrugKing holds a call option, written by InsureAll, on the Series A preferred stock, which will allow it to repurchase the asset from InsureAll two years after the transfer date. DrugKing attaches a call option directly to the Series B preferred stock that will allow it to repurchase the asset from whoever owns the asset up to two years after the transfer date. Both options have a fixed exercise price.

Outside counsel for DrugKing concludes that both transfers isolate the transferred assets (i.e., the assets have been put presumptively beyond the reach of DrugKing and its creditors, even in bankruptcy or other receivership).

Example 2

DrugKing transfers a financial asset, its investment in a debt security, to InsureAll, a substantive third party. The asset is traded publicly (i.e., it is readily obtainable in the marketplace).

DrugKing holds a conditional call that is attached to the asset. This call will permit DrugKing to repurchase the asset if LIBOR ever decreases below 4 percent (LIBOR was 6.5 percent as of the date of transfer). The option has a fixed exercise price.

Outside counsel for DrugKing concludes that the transfer isolates the transferred asset (i.e., the assets have been put presumptively beyond the reach of DrugKing and its creditors, even in bankruptcy or other receivership).

Example 3

DrugKing transfers two financial assets, its trade receivables and its credit card receivables, to InsureAll, a substantive third party. Neither asset is readily obtainable in the marketplace.

The trade receivables have a fair value of \$100 (book value is \$99) and were transferred to InsureAll for \$103. The transfer includes an option for InsureAll to put the assets back to DrugKing for up to one year after the transfer date at \$102.50. The transfer price of \$103 represents the fair values of the trade receivables (\$100) and the put option (\$3).

The credit card receivables have a fair value of \$100 (book value is \$99) and were transferred to InsureAll for \$150. The transfer includes an option, which expires in 10 days, for InsureAll to put the assets back to DrugKing at \$151. The possibility of the fair value of the asset increasing to \$151 in 10 days is considered remote and, therefore, the exercise price of the option appears to be sufficiently favorable such that it is probable at inception that it will be exercised. The transfer price of \$150 represents the fair values of the credit card receivables (\$100) and the put option (\$50).

Outside counsel for DrugKing concludes that both transfers isolate the transferred assets (i.e., the assets have been put presumptively beyond the reach of DrugKing and its creditors, even in bankruptcy or other receivership).

Required:

How should DrugKing account for each of the asset transfers in the examples above (i.e., may the asset transfers be accounted for as a sale)?