

Chapter 6

How do you determine gain or loss on a sale?

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Simplified gain or loss calculation

Say what you want about the evolution of accounting guidance for transfers of financial assets over the years, but at least the calculation of gain or loss on sale of assets has been greatly simplified. There are three principal reasons for this:

- Achieving sale accounting and deconsolidation is now a higher hurdle than had previously been the case.
- Under ASC 860, one can sell only an entire financial asset, a pool of entire assets, or a participating interest; no part sale/part financing.
- Retained or acquired interests are initially recorded at fair value rather than allocated cost basis.

Many of the steps in the process of calculating a gain or loss on sale will sound familiar. It remains useful to remember that for a securitization that has achieved sale accounting, the transferor has sold a pool of entire assets. There are no “retained” pieces—any beneficial interests received are all proceeds.

To calculate the gain or loss, sellers must first accumulate the elements of carrying value of the pool of assets securitized, including any premiums and discounts, capitalized fees or costs and lower-of-cost-or-fair-value valuation reserves.¹ Second, sellers must identify any assets received and any liabilities incurred as part of the securitization. Third, sellers must estimate carefully the fair values of every element received or incurred based on current market conditions. Finally, for those transfers that qualify as a sale, sellers must:

- Recognize gain or loss on the assets sold by comparing the net sale proceeds (after transaction costs and liabilities incurred) to the carrying value attributable to the assets sold.
- Record as proceeds, and on the balance sheet at fair value, any beneficial interest received in the transferred assets, which may include: (1) a separate servicing asset or liability and/or (2) debt or equity instruments issued by the SPE.
- Subtract from proceeds and record on the balance sheet the fair value of any new liabilities issued, including guarantees; recourse obligations or derivatives, such as written put options; forward commitments; and interest rate or foreign currency swaps.

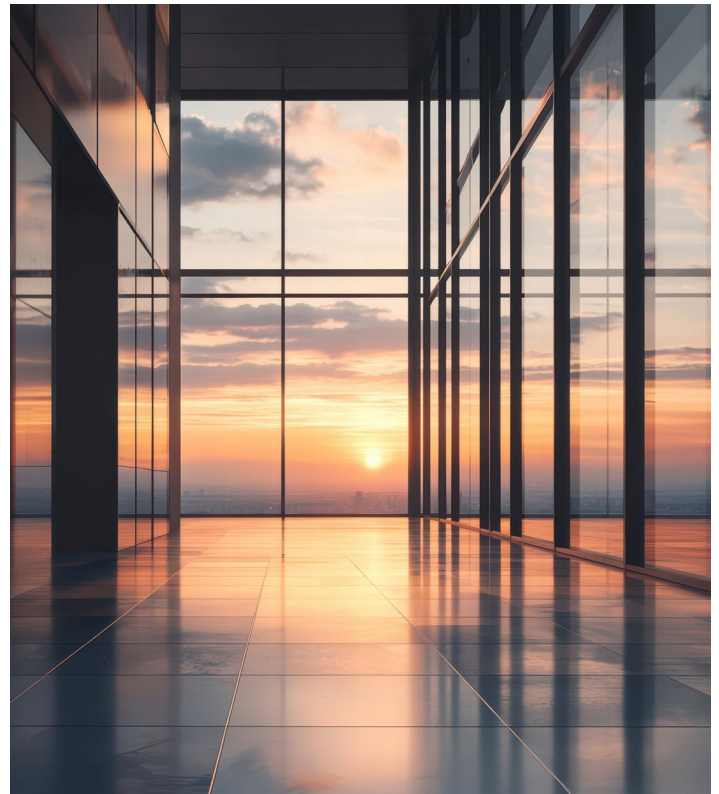
Financial modeling of securitization transactions is an integral part of the accounting process, both at the date of the transaction and on an ongoing basis. Reasonable financial modeling requires quantitative processes that appropriately reflect: (1) the nature of the assets securitized, (2) the structural features and terms of the securitization transaction, and (3) the applicable accounting theory. It also requires accurate data about current amounts and balances in the securitization, as well as observable market data (e.g., yield curves and credit spreads) and supportable assumptions about

future events (e.g., prepayment behavior, default probability, and loss severity). Securitization transactions are too complex to analyze intuitively, given the level of precision required for financial reporting.

How is gain or loss calculated in that rare revolving structure that does not have to be consolidated?

Gain or loss recognition for relatively short-term receivables, such as credit card balances, drawdowns on home equity lines of credit, trade receivables, or dealer floor plan loans sold to a relatively long-term revolving securitization trust, is limited to receivables that exist and have been sold (i.e., not those that will be sold in the future pursuant to the revolving nature of the deal). Recognition of servicing assets is also limited to the servicing for the receivables² that exist and have been sold.

A revolving securitization involves a large initial transfer of balances generally accounted for as a sale. Ongoing, smaller subsequent months’ transfers funded with collections of principal from the previously sold balances (“transferettes”) are each treated as separate sales of new assets with the attendant gain or loss calculation, provided that these transfers meet the unit of account definition discussed in [chapter 3](#). The recordkeeping burden necessary to comply with these techniques can be quite onerous, particularly for master trusts.



¹ When assets are transferred from held-for-investment to held-for-sale, credit allowances are generally reversed (i.e., as opposed to being recognized in the gain or loss on sale); see, e.g., ASC 310-10-35-48A and ASC 948-310-35-2A.

² Transfers of receivables associated with revolving accounts (e.g., credit cards) may not qualify for sale accounting due to ASC 860’s participating interest requirements.

The implicit forward contract to sell new receivables during a revolving period, which may become more or less valuable as interest rates and other market conditions change, is to be recognized at its fair value at the time of sale. Its value at inception will be zero if entered into at the market rate. ASC 815, *Derivatives and Hedging*, may require securitizers to mark the forward to fair value in accounting periods following the securitization, but it is outside the scope of this publication, as are any considerations of electing fair value accounting under ASC 825, *Financial Instruments*.

Certain revolving structures use a “bullet provision” as a method of distributing cash to their investors. Under a bullet provision, during a specified period preceding liquidating distributions to investors, cash proceeds from the underlying assets are reinvested in short-term investments, as opposed to continuing to purchase revolving period receivables. These investments mature to make a single lump sum or

“bullet” payment to certain classes of investors on a predetermined date. In a controlled amortization structure, the investments mature to make a series of scheduled payments to certain classes of investments on predetermined dates. As stated earlier in this chapter, sellers must record as proceeds any beneficial interests received, and the bullet or controlled amortization provision should be taken into account in determining the fair values of the beneficial interests received, assuming that the beneficial interests are issued by an unconsolidated trust.

That said, for transferred credit card receivables, it is inappropriate to report as “loans receivable” the receivables for income related to accrued fees and finance charges income, commonly referred to as accrued interest receivable (AIR). The AIR asset should be accounted for as a beneficial interest received in the pool.



Is there a sample gain on sale worksheet that I can use as a template?

A term securitization example

Assumptions (All amounts are hypothetical, and the relationships between amounts do not purport to be representative of actual transactions.)

- Aggregate principal amount of pool: \$100,000,000
- Net carrying amount (principal amount + accrued interest [if it must be remitted to the trust] + purchase premium + deferred origination costs – deferred origination fees – purchase discount): \$99,000,000
- Classes IO and R are acquired by transferor

Deal structure			
Scenario	Principal amount	Price*	Fair value
Class A	\$96,000,000	100%	\$96,000,000
Class B	4,000,000	95	3,800,000
Class IO			1,500,000
Class R			1,000,000
Total	\$100,000,000		\$102,300,000

*Including accrued interest

Servicing asset at fair value \$700,000

Up-front transaction costs \$1,000,000
(underwriting, legal, accounting, rating agency, printing, etc.)

Calculation of gain	
Total proceeds	
Total cash from bond classes sold, Class A & B (net of transaction costs)	\$98,800,000
Class IO (fair value)	1,500,000
Class R (fair value)	1,000,000
Servicing asset (fair value)	700,000
Net proceeds (with accrued interest, after transaction costs)	\$102,000,000
Net carrying amount	\$99,000,000
Pretax gain on sale	\$3,000,000

Journal entries	Debit	Credit
Cash	\$98,800,000	
Servicing asset	\$700,000	
Class IO	\$1,500,000	
Class R	\$1,000,000	
Loans — net carrying amount		\$99,000,000
Pretax gain on sale		\$3,000,000

What about sales of participating interests?

Assume Commercial Loan Bank and Trust (CLBT) has sold an eight-tenths participating interest in a commercial loan with a carrying amount of \$20,000,000 to Partaker Bank for \$15,200,000. Additionally, CLBT has sold a 10 percent participating interest in the same loan to Group Bank for \$1,900,000. Given the total cash proceeds are \$17,100,000 and the participating interests were sold at fair value, it implies that the fair value of the loan is \$19,000,000. Thus, CLBT's remaining 10 percent interest would stay on the books at a basis of \$2,000,000 (multiplying the carrying amount by the percentage retained). This participation transaction would not give CLBT an opening to elect to carry that interest at fair value.

This example may be slightly oversimplified. In the first instance, even though they are buying their interests at the same time, Partaker Bank and Group Bank might pay somewhat different prices. Also, the example ignores servicing, which could result in a liability (if the servicing fee would not fairly compensate a substitute servicer) or a small asset (however, the fee cannot be significantly above fair compensation and still meet the participating interest definition).

Basis allocation of carrying value					
Component	Fair value	% of total fair value	(\$20 million × %) Allocated carrying amount	Allocated carrying amount	
				Sold	Retained
Sold to Partaker Bank	\$15,200,000	80%	\$16,000,000	\$16,000,000	
Sold to Group Bank	1,900,000	10	2,000,000	2,000,000	
Interest held by CLBT	1,900,000	10	2,000,000		\$2,000,000
Total	\$19,000,000	100%	\$20,000,000	\$18,000,000	\$2,000,000
Net proceeds				\$17,100,000	
Pretax loss				\$900,000	

Journal entries	Debit	Credit
Cash	\$17,100,000	
Loss on sale	\$900,000	
Loans — net carrying amount		\$18,000,000

How do I calculate fair value?

Because it would be unusual for a securitizer to find quoted market prices for many financial components arising in a securitization, the measurement process requires estimation techniques. ASC 860 discusses these situations as follows:

- The underlying assumptions about interest rates, default rates, prepayment rates, and volatility should reflect what market participants would use.
- Estimates of expected future cash flows should be based on reasonable and supportable assumptions and projections.
- All available evidence should be considered, and the weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively.

For further discussion on fair value see [chapter 9](#).

How do I record credit risk? Is it part of the beneficial interest in the asset?

The transferor should focus on the source of cash flows in the event of a loss by the trust. If the trust can only look to cash flows from the underlying financial assets, the transferor is absorbing a portion of the credit risk through its beneficial interest and should not record a separate obligation. However, possible credit losses from the underlying assets do affect the measurement of fair value and accounting for the transferor's beneficial interest. In contrast, if the transferor could be obligated to reimburse the trust beyond losses charged to its beneficial interest (i.e., it could be required to "write a check" to reimburse the trust or others for credit-related losses on the underlying assets or the trust—investors have the right to put assets back to the transferor), then a separate liability should be recorded at fair value on the date of transfer.

Caution: Should this fact pattern present itself, care should be taken in the determination of whether the transferor should consolidate the transferee and if legal isolation has been achieved.

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