

Hot Topic

Update on major accounting
and auditing activities



FASB releases exposure draft on amendment to FAS 140

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Overview

On 15 September 2008, the FASB released a Proposed Statement of Financial Accounting Standards, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140* (Proposed Statement). The Proposed Statement, which is a revision of the August 2005 FASB Exposure Draft of the same name, is in response to the FASB's concerns about how practice has developed under Statement 140, as well as concerns expressed by constituents that certain transfers should not qualify as sales under Statement 140. Additionally, financial statement users have expressed concerns about the transparency of disclosures as a result of significant events in the credit markets. The FASB recognized the need for a change in the derecognition model to identify situations in which the transferor continues to maintain control of the transferred financial assets to such an extent that derecognition of the financial assets is not appropriate.

The Proposed Statement would remove the concept of a qualifying special-purpose entity (SPE) from Statement 140 and remove the exception from applying FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* (FIN 46(R)) to qualifying SPEs.

In addition, the Proposed Statement would:

- ▶ Clarify that the objective of the isolation analysis required pursuant to paragraph 9(a) of Statement 140 is to determine whether a transferor and all of the entities included in the financial statements being presented have surrendered control over the transferred financial assets. This determination must consider all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer.
- ▶ Establish conditions for reporting transfers of a *portion* of a financial asset as a sale. In so doing, the Proposed Statement defines a new term, *Participating Interest* (discussed below).
- ▶ Remove from Statement 140 and FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, the special provisions for guaranteed mortgage securitizations and require them to be treated the same as any other transfer of financial assets within the scope of Statement 140, as amended.

- ▶ Require all transferor retained interests to be initially measured at fair value when the transfer is accounted for as a sale.
- ▶ Require enhanced disclosures.

In conjunction with the Proposed Statement, the FASB issued an Exposure Draft to amend FIN 46(R), *Amendments to FASB Interpretation No. 46(R)*. The FIN 46 (R) amendments would:

- ▶ Require continuous assessments of whether an entity is a variable interest entity (VIE) and whether an enterprise is the primary beneficiary of a VIE.
- ▶ Amend the guidance for determining the primary beneficiary of a VIE by requiring an enterprise to initially perform a qualitative analysis to determine if the enterprise's variable interest(s) gives it a controlling financial interest.
- ▶ Significantly expand the disclosure requirements for enterprises with involvement with VIEs.

The criteria for determining whether an entity is a VIE would be unchanged.

Refer to our separate Hot Topic on the proposed amendments to FIN 46(R).

Background

The road to the Proposed Statement has been long. Statement 140, which was issued in September 2000 as a replacement of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, provides accounting and financial reporting guidance for sales, securitizations, servicing of receivables and other financial assets, and for secured borrowing and collateral transactions. Since its issuance, questions have been raised about the permitted activities of a qualifying SPE. To address some of these questions, the Emerging Issues Task Force attempted to clarify certain issues but could not reach a consensus on the issues before it. Because a

qualifying SPE generally was exempt from consolidation, the FASB decided that it was important to clarify its characteristics. As a result, the FASB undertook a project on the permitted activities of qualifying SPEs. As the project progressed, the FASB decided that other aspects of Statement 140 required clarification or improvement, including issues related to isolation and the initial measurement of interests in transferred financial assets that continue to be held by the transferor.

The project resulted in the issuance of an Exposure Draft in June 2003 dealing with issues related to qualifying SPEs and isolation of transferred assets. As a result of information obtained through the comment and redeliberation process, the FASB reached certain conclusions during redeliberations that were substantially different from the June 2003 Exposure Draft. This resulted in the FASB issuing a revised Exposure Draft in August 2005. The Proposed Statement is the result of deliberations on comments received on the August 2005 Exposure Draft, subsequent constituent inquiries (including financial statement user requests for greater transparency), and market conditions over the past three years, including, but not limited to, the recent credit crisis in the United States.

Proposed changes

Qualifying SPEs

The FASB originally developed the conditions for qualifying SPEs primarily to permit derecognition of assets in certain transactions in which the transferee is a passive entity that cannot pledge or exchange the transferred financial assets. The FASB developed conditions for a qualifying SPE that were designed such that consideration of consolidation would not be pertinent because the entity would be so passive that control could not be an issue. The FASB has indicated that, in practice, the conditions for a qualifying SPE are being applied more broadly

than originally intended. The FASB believes that the range of financial assets being securitized and the complexity of securitization structures and arrangements have resulted in the qualifying SPE criteria being stretched in some cases beyond the intent and requirements of Statement 140. As a result, and after much consideration, the FASB decided to remove the concept of a qualifying SPE from Statement 140.

Isolation of transferred assets

Statement 140 includes a requirement that, except for certain bankruptcy-remote entities, transferred financial assets must be isolated from any entities in the transferor's consolidated group. Because of questions and inconsistencies in practice, the FASB decided to clarify the requirements for isolation. In so doing:

- ▶ The FASB concluded that transferred financial assets are isolated in bankruptcy or other receivership only if the available evidence provides reasonable assurance that the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates included in the financial statements being presented.
- ▶ The FASB clarified that the determination whether financial assets are isolated must consider all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer.
- ▶ The FASB provided additional guidance on the nature of the legal opinions often required to support a conclusion that a true-sale has occurred.

Transfers of portions of financial assets

The Proposed Statement would provide conditions on when a transfer of a portion of a financial asset would be reported as a sale. If the transfer does not meet these conditions, sale accounting could be achieved only by transferring an entire

financial asset or a group of financial assets that otherwise meet the derecognition criteria. In establishing the specific conditions, the Proposed Statement would define the term *participating interest*. A participating interest is a portion of a financial asset that conveys proportionate ownership rights with equal priority to each participating interest holder; involves no recourse to, or subordination by, any participating interest holder; and does not entitle any participating interest holder to receive cash before any other participating interest holder. In order to report a transfer of a portion (or portions) of a financial asset as a sale, the transferred portion (or portions) and any portions that continue to be held by the transferor must be participating interests and the transferor must otherwise meet the conditions for surrender of control in Statement 140.

Removal of exception for guaranteed mortgages

Statement 65 requires that a securitization of a mortgage loan held for sale be accounted for as a sale of the mortgage loan and a purchase of a mortgage-backed security, even if the transaction does not meet the requirements for sale accounting. Statement 140 requires that a transferor recognize a servicing asset or servicing liability at fair value if the transferor transfers mortgage loans to a qualifying SPE in a guaranteed mortgage securitization and retains all of the resulting securities. The FASB questioned whether it was appropriate to reclassify a financial asset as a security, which could result in a change in the measurement attribute for financial assets, when a transferor has not met the requirements for sale accounting. Accordingly, the Board decided to delete the exception for guaranteed mortgage securitizations as they do not believe it is appropriate to provide an exception for only one asset type that would enable a transferor to recognize a gain or loss when the transferor has not met the requirements for sale accounting.

Measurement of a transferor's beneficial interest

Statement 140 requires beneficial interests that continue to be held by a transferor to be measured by allocating the carrying amount of the transferred assets between the financial assets sold and the financial assets retained based on their relative fair values. After the FASB's decision to amend Statement 140 for transfers of portions of financial assets, they reconsidered the nature of a transferor's beneficial interest in the transferred assets. The Board concluded that any beneficial interest or other asset or liability that the transferor receives in a qualifying sale is proceeds of the sale and represents a new asset or liability to the transferor. Accordingly, the Board concluded that a retained interest issued by an entity that the transferor does not consolidate should be initially recorded by the transferor at fair value.

Disclosures

In response to financial statement users' need for additional information about transferred assets, particularly when the transferor has continuing involvement, the Proposed Statement would add disclosure requirements to provide users of financial statements with greater transparency about transfers of financial assets and a transferor's continuing involvement with such transferred assets.

Effective date and transition

The Proposed Statement would be effective for transfers occurring on or after the beginning of a reporting entity's first fiscal year that begins after 15 November 2009, with earlier application prohibited. That is, the Proposed Statement is effective for calendar-year companies beginning in 2010.

Additionally, on the effective date, all existing qualifying SPEs must be evaluated for consolidation by all reporting entities in accordance with all applicable consolidation guidance, including the amended FIN 46(R), as

discussed above. If such an evaluation results in consolidation, the reporting entity will apply the transition guidance provided in the pronouncement that requires consolidation.

Given current market conditions, the Board also issued a FASB Staff Position (FSP) on 15 September 2008 that would amend the disclosure provisions of both Statement 140 and FIN 46(R) to expedite the effective date of the disclosure provisions of the Proposed Statement and the Exposure Draft on FIN 46(R). The disclosure amendments made to Statement 140 by the FSP would be substantially the same as the Proposed Statement and would only be applicable to public entities. The amended disclosure requirements could be effective for the 31 December 2008 financial statements for calendar-year companies. Developments in this area should be monitored closely.

Potential effects

The Proposed Statement will have a significant effect on existing securitizations that use qualifying SPEs, as well as future securitizations. Currently, transferors of financial assets to qualifying SPEs do not consolidate the SPE by virtue of the SPEs "qualifying" status, in spite of the fact that the transferor might retain a significant residual interest in the qualifying SPE's transferred assets. Once the concept of a qualifying SPE is removed from Statement 140, along with the related scope exception in FIN 46(R), many existing securitization vehicles likely will be consolidated by the transferor. Affected entities will need to determine how this might affect relevant financial ratios, debt covenants or regulatory capital requirements, where applicable. Of course, it may be theoretically possible to restructure existing securitizations and sell enough of the retained interest so that consolidation of the entity is not required under FIN 46(R). However, any changes required to the existing structure likely will require approval by existing beneficial interest holders in those SPEs, who may not

agree to the changes. Going forward, companies will not be able to retain significant retained interests in SPEs that own the transferred assets, or provide significant credit enhancement to the SPE, else they could potentially become the primary beneficiary of the SPE, requiring consolidation. However, potential investors may not want to invest in a securitization in which the transferor has no economic interest in the SPE.

The conditions established in the Proposed Statement related to transfers of a portion (or portions) of financial assets will affect many transfers to commercial paper conduits, as those conduits currently hold senior undivided interests in the related receivables, as opposed to the receivables themselves. Going forward, in order for those transfers to receive sale treatment, the receivables themselves will need to be transferred to the commercial paper conduit or the interests in those receivables held by the conduit will need to conform to the requirements of a participating interest.

With respect to the removal of the exception for guaranteed mortgage securitizations, entities that entered into these transactions will no longer be able to recharacterize the transferred assets unless they meet the sale criteria of Statement 140 and are not the primary beneficiary of the securitization vehicle.

Finally, assuming consolidation of the securitization SPE is not required, the requirement to now consider retained interests in the transferred assets as proceeds to be initially measured at fair value will affect the amount of gain or loss to be recognized in future securitizations as well as the amount of future income to be recognized on the retained interest.

Next steps

The Proposed Statement is open for comment until 14 November 2008. In addition, the FASB plans to hold a public roundtable meeting on the Proposed Statement on 6 November 2008. Financial statement preparers and users should provide any feedback to the FASB through the comment letter process. We encourage you to continue to monitor developments in this area. As an immediate step, we encourage enterprises to inventory their qualifying SPEs to begin to evaluate the effect of the Proposed Statement on those securitizations. Absent substantial changes to the terms of those securitizations (if possible), many of additional SPEs will be consolidated. In that event, preparers will be required to gather and analyze significant amounts of data to initially apply the applicable consolidation guidance to those entities. We will continue to monitor the changes to Statement 140 and provide further guidance as these projects progress.

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