JANUARY 15, 2013

FASB In Focus

Proposed Accounting Standards Update—*Transfers and Servicing (Topic 860)—Effective Control for Transfers with Forward Agreements to Repurchase Assets and Accounting for Repurchase Financings*

Introduction

On January 15, 2013, the FASB issued a proposed Accounting Standards Update, *Transfers and Servicing (Topic 860)—Effective Control for Transfers with Forward Agreements to Repurchase Assets and Accounting for Repurchase Financings.* The proposed Update is intended to improve guidance for determining whether repurchase agreements and other transfers of financial assets with forward agreements to repurchase the assets should be accounted for as sales or secured borrowings and disclosures about those transactions.

What Are Repurchase Agreements?

Repurchase agreements are transactions in which a transferor transfers a financial asset to a transferee in exchange for cash and concurrently agrees to reacquire that financial asset at a future date for an amount equal to the cash exchanged plus a stipulated interest factor. Repurchase agreements are used by some companies and institutions as a source of short-term financing on a collateralized basis, allowing lenders in this market to invest money on a secured, short-term basis. For example, an investment fund might enter into a repurchase agreement with a bank. Under that contract, the bank, or transferor, sells securities to the investment fund, or transferee, and agrees to repurchase the securities at a specific date in the future for a price that is sufficient to cover the fund's original purchase price, plus an additional return on investment. During the term of a typical repurchase agreement, the transferee can obtain certain benefits of the transferred financial assets by selling or pledging the transferred assets.

Repurchase agreements and other transfers of financial assets with forward agreements to repurchase the assets are unique because they typically involve shared rights to the transferred assets, and therefore possess attributes of both sales and secured borrowings. Determining whether these transactions are sales or secured borrowings often rests on an evaluation of whether the transferor maintains "effective control" over the transferred financial assets.

Why Are We Doing This Project?

As part of its ongoing monitoring of financial reporting issues in the capital markets, the Board was made aware of issues related to application of effective control guidance. Under current U.S. Generally Accepted Accounting Principles (GAAP), effective control over a transferred financial asset is maintained by a transferor, and on-balance-sheet secured borrowing accounting is required, if there is a contemporaneous forward agreement that requires the transferor to repurchase the same or "substantially the same" financial asset at a fixed price from the transferee before its maturity. However, effective control is not maintained if a transferor will not recover the transferred asset at the conclusion of the agreement because the asset has matured, resulting in sale accounting if other criteria are met.

Current accounting guidance distinguishes between repurchase agreements that settle at the same time as the transferred financial asset matures (commonly referred to as a "repurchase-to-maturity" agreement), and those that settle before the transferred financial asset matures. However, stakeholders noted that an accounting distinction between those agreements is unwarranted because, during the term of both types of transactions, the transferor retains exposure to the credit risk related to the transferred financial assets and obtains certain benefits of those assets.

The Board also recognized that the market for repurchase agreements has changed significantly since 1996, when the Board first issued guidance in this area in FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* They increasingly have involved asset types beyond U.S. Treasury and government agency securities that may be less liquid and, consequently, may affect how the transactions operate and how investors consider the risks associated with them.

Finally, some stakeholders raised concerns about the practical application of the guidance for assessing the transferor's effective control related to whether the financial assets to be repurchased under such agreements are considered "substantially the same" as the assets initially transferred. Outreach to investors and other financial statement users also confirmed that disclosures for repurchase agreements and other transfers with forward agreements to repurchase the transferred assets should be improved, especially regarding the effect of these transactions on the transferor's risk profile.

What Is the FASB Proposing in This Exposure Draft?

A repurchase agreement or other transaction that involves the transfer of a financial asset and a contemporaneous forward agreement that requires the transferor to repurchase the transferred asset that meets all of the following criteria would maintain the transferor's effective control over the transferred financial asset and, therefore, be accounted for as a secured borrowing transaction:

- The financial asset to be repurchased at settlement of the agreement is identical to or "substantially the same" as the financial asset transferred at inception or, when the settlement of the forward agreement to repurchase the transferred asset is at the maturity of the transferred asset, the agreement is settled through an exchange of cash (or a net amount of cash)
- The repurchase price is fixed or readily determinable and
- The agreement to repurchase the transferred financial asset is entered into contemporaneously with, or in contemplation of, the initial transfer.

Accounting for a transfer of a financial asset with a forward agreement to repurchase the transferred asset at its maturity as a secured borrowing during the term of the agreement would result in financial reporting that is more comparable with International Financial Reporting Standards (IFRS).

Under the proposed amendments, transactions involving the transfer of a financial asset and a contemporaneous forward agreement to repurchase the transferred asset that do NOT maintain the transferor's effective control over the transferred asset would be required to be assessed under the remaining derecognition conditions in current U.S. GAAP to determine whether they should be accounted for as secured borrowings or sales with forward repurchase agreements (generally, a derivative).

The proposal also would clarify the characteristics of assets that may be considered "substantially the same" under the effective control guidance.

In addition, the proposal would change the accounting for transactions comprised of an initial transfer and related repurchase financing. For those transactions, the proposed amendments would eliminate the current requirement to assess whether a repurchase agreement entered into as a repurchase financing of a previously transferred asset should be linked with the initial transfer and accounted for on a combined basis in certain circumstances. Instead, the transferor would be required to separately account for the initial transfer and repurchase financing of the previously transferred asset.

Finally, the proposal would require two new disclosures for certain transfers of financial assets with forward agreements that require the transferor to repurchase the transferred financial asset from the transferee.

For agreements accounted for as secured borrowings, a transferor would be required to disclose the gross amount of the total borrowing disaggregated based on the class of financial asset pledged as collateral.

For agreements accounted for as sales only because the assets to be repurchased are not considered to be "substantially the same" as the initially transferred assets, the proposal would require a transferor to disclose the carrying amount of assets derecognized during the reporting period. If that amount has significantly changed since the previous balance sheet date, the reporting organization also would need to disclose the reasons for the change.

Who Would Be Affected by the Proposed Update?

The proposed Update would affect both public and nonpublic organizations that enter into agreements to transfer financial assets that require the transferor to repurchase the financial assets.

When Would the Proposed Update Be Effective?

The Board will establish the effective date of the requirements when it issues the final amendments, based on input it receives on the proposal.

For transfers with forward repurchase agreements that settle at the maturity of the transferred financial asset and repurchase financings that involve such agreements, an entity would apply the proposed amendments by means of a cumulative-effect adjustment to beginning retained earnings as of the beginning of the first reporting period in which the guidance is effective. For all other transactions, an entity would apply the proposed amendments prospectively to transactions entered into or modified after the effective date.

For more information about the project, please visit the FASB's website at www.fasb.org.

Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, Connecticut 06856-5116
T: 203.847.0700 | F: 203.849.9714