

Wogan Bernard was recently appointed as Vice-Chairman of the Governmental Incentives Committee of the ABA Section of Real Property, Trust & Estate Law for the 2009-2010 bar year.

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# UPDATE ON THE AMENDMENTS TO FAS 140—ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS AND REPURCHASE FINANCING TRANSACTIONS

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## I. Background

The Financial Accounting Standards Board (“FASB”) has continued to progress in its amendments to FAS 140<sup>2</sup>, *Accounting for Transfers and Servicing of Financial Assets and Extinguishing Liabilities*. The Board has recently adopted rules that eliminate special purpose entities as an accounting tool, which will in turn affect how banks account for off-balance-sheet entities.

**a. The FASB:** Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting and reporting.<sup>3</sup> These standards govern the preparation of financial reports and are officially recognized as authoritative by the Securities and Exchange Commission and the American Institute of Certified Public Accountants.<sup>4</sup>

**b. FAS-140:** Financial Accounting Standards, or FAS 140 govern the accounting rules for transfers and servicing of financial assets. FAS 140 was originally implemented in September of 2000. It replaced the old FASB Statement No. 125 and revised the standards of accounting for securitizations and other transfers of financial assets and collateral.<sup>5</sup> FAS 140 requires certain disclosures, but carried over most of Statement 125’s provisions without reconsideration. FAS 140’s accounting standards are based on consistent application of a *financial-components approach* that focuses on control.<sup>6</sup> Under this approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred while derecognizing financial assets when control has been surrendered, and derecognizes liabilities when extinguished.<sup>7</sup> Generally, a transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration, other than beneficial interest in the transferred assets, is received in the exchange.

A transferor has surrendered control if all of the following conditions are met:

1. The transferred assets have been isolated from the transferor, and they are presumptively beyond the reach of the transferor and its creditors.

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<sup>2</sup> Financial Accounting Standard 140.

<sup>3</sup> Reuters, FASB Issues Exposure Draft to Amend Statement 140 and Interpretation 46(R) (September 15, 2008), <http://www.reuters.com/article/pressRelease/idUS210960+15-Sep-2008+BW20080915>

<sup>4</sup> *Id.*

<sup>5</sup> FASB, Summary of Statement No. 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, <http://www.fasb.org/st/summary/stsum140.shtml>.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

2. Each transferee has the right to pledge or exchange the assets it received, and there is no condition on its right to pledge or exchange.

3. The transferor does not retain control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem the assets before their maturity or (2) the ability unilaterally to cause the holder to return the specific assets.<sup>8</sup>

**c. SPE:** Special Purpose Entities (SPEs), also referred to as off-balance-sheet arrangements, have been in use since the 1970s when companies began engaging in securitization.<sup>9</sup> These off-balance sheet arrangements are called qualifying special purpose entities (QSPEs) if they meet the requirements set forth in FAS 140.<sup>10</sup> In basic terms, an off-balance sheet entity is created by a party, the transferor, by transferring assets to another party, the special purpose entity, to carry out a specific purpose, activity, or series of transactions.<sup>11</sup>

SPEs are created to accomplish three general objectives:

- 1) Financing certain assets or servicing and keeping the associated debt off the balance sheet of the transferor;
- 2) Transforming certain financial assets, such as trade receivables, loans, or mortgages, into liquid security; and
- 3) Engaging in tax-free exchanges.<sup>12</sup>

These off-balance-sheet entities can benefit the transferor in two ways. First, an SPE enables the transferor to remove debt from its balance sheet so it meets certain ratios and loan covenants. Second, such arrangements protect the transferor from possible financial failure by its SPE.<sup>13</sup> Thus, if the project for which an SPE was created fails, the transferor is at risk only for what it has put into the SPE. In addition, these SPEs enable the transferor to add more debt, some of which could be risky.

Again, the SPEs' main functions are in the area of securitization. Securitization is a process by which securities are created whose payments are supported by cash flows generated by a pool of financial assets.<sup>14</sup> This process provides funding to the marketplace, thereby helping to ensure that consumers can obtain the necessary credit.<sup>15</sup> SPEs in securitization simply

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<sup>8</sup> *Id.*

<sup>9</sup> Jalal Soroosh and Jack T. Ciesielski, Accounting for Special Purpose Entities Revised: FASB Interpretation 46(R), The CPA Journal, <http://www.nysscpa.org/cpajournal/2004/704/essentials/p30.htm>.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* It should be noted that the transferor will also have to remove from its balance sheet the assets related to the debt that has been moved to the SPE.

<sup>14</sup> Special Purpose Entities (SPEs) and the Securitization Markets (February 1, 2002), <http://www.isda.org/speeches/pdf/SPV-Discussion-Piece-Final-Feb01.pdf>.

<sup>15</sup> *Id.*

act as a depository for a specific group of assets in a securitization, and in turn, issue securities to the marketplace for purchase by investors.<sup>16</sup>

FAS 140 as it was originally written in 2000 specifically defined a qualifying SPE as a trust or other legal vehicle that meets all of certain specific conditions.<sup>17</sup>

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<sup>16</sup> *Id.*

<sup>17</sup> See Financial Statements of Accounting Standards No. 140 (September 2000), <http://fasb.org/pdf/fas140.pdf>:

35. A qualifying SPE is a trust or other legal vehicle that meets *all* of the following conditions:
- a. It is demonstrably distinct from the transferor (paragraph 36).
  - b. Its permitted activities (1) are significantly limited, (2) were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds, and (3) may be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 37 and 38).
  - c. It may hold only:
    - (1) Financial assets transferred to it that are passive in nature (paragraph 39)
    - (2) Passive derivative financial instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 39 and 40)
    - (3) Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE
    - (4) Servicing rights related to financial assets that it holds
    - (5) Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds (paragraph 41)
    - (6) Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).
  - d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:
    - (1) Occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 42 and 43)
    - (2) Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder's beneficial interest back to the SPE (paragraph 44)
    - (3) Exercise by the transferor of a call or ROAP specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 51–54 and 85–88)
    - (4) Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 45).

## II. Amending FAS 140

As QSPEs and SPEs became more commonplace, their structure and use became more sophisticated. As a result, the accounting standards dealing with off-balance-sheet entities produced inconsistent results as the standards were incomplete and fragmented.<sup>18</sup>

In the wake of the Enron scandal, which brought to light the use of SPEs as a tool to enhance a company's bottom line, FASB responded by issuing a proposed interpretation of existing accounting principles aimed at putting many off-balance-sheet entities back onto the balance sheet of companies that had created them.<sup>19</sup> In June of 2002, the FASB issued an exposure draft to revise accounting for SPEs.<sup>20</sup> Beginning in January of 2003, the FASB expanded its project to examine amending FAS 140, focusing on the permitted activities of a qualifying SPE and other practices that may permit a transferor to derecognize a financial asset.<sup>21</sup> In August of 2005, the FASB issued an Exposure Draft regarding proposed amendment to Statement 140. A total of 53 comment letters were received from respondents to the Exposure Draft. The majority of respondents generally objected to the changes proposed by the Exposure Draft.<sup>22</sup> As a result of these comments, the Board decided to redeliberate significant issues raised by respondents prior to the issuance of a final amendment.<sup>23</sup> Again, the general focus of this initial amendment was to address the permitted activities of a qualifying SPE.<sup>24</sup>

Beginning in the fall of 2008, in light of the sub-prime mortgage crisis, FASB had decided to eliminate the qualifying special purpose entity. In discussing this issue in a joint meeting with FASB and its European counterpart, the International Accounting Standards Board, FASB Chairman, Robert Herz, explained that the "vehicles into which riskier loans had been packaged were 'ticking time bombs.'"<sup>25</sup>

On September 15, 2008, the FASB issued three separate but related Exposure Drafts for public comment.<sup>26</sup> These proposed amendments impose disclosure requirements on non-

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<sup>18</sup> Jalal Soroosh and Jack T. Ciesielski, "Accounting for Special Purpose Entities Revised: FASB Interpretation 46(R), The CPA Journal, <http://www.nysscpa.org/cpajournal/2004/704/essentials/p30.htm>.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> See FASB, [http://www.fasb.org/project/transfers\\_of\\_financial\\_assets.shtml#due\\_process](http://www.fasb.org/project/transfers_of_financial_assets.shtml#due_process).

<sup>22</sup> The respondents who objected generally called for a clarification on issues that concerned the use of QSPEs. See Ed Zwrin, FASB To Propose QSPE Killoff, Markets Media Online (March 13, 2008), <http://www.marketsmediaonline.com/archive.htm?wP=1&wPI=1>.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> See Revised Exposure Draft for Proposed Statement for Financial Accounting Standards, [http://www.fasb.org/draft/ed\\_transfers\\_financial\\_assets\\_amend\\_st140.pdf](http://www.fasb.org/draft/ed_transfers_financial_assets_amend_st140.pdf). Furthermore, the three drafts are: The proposed FASB Statements, Accounting for Transfers of Financial Assets, and Amendments to FASB Interpretation No. 46(R), address amendments to FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, and to FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities. Proposed FASB Staff Position FAS 140-e and FIN 46 (R)-e, Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities, address related disclosure requirements for public entities.

transferors and eliminate the QSPE itself as an acceptable accounting practice.<sup>27</sup> The proposed amendments to FAS 140 can be summed up as follows:

1. The amendments would remove the concept of a qualifying SPE from Statement 140 and would remove the exception from applying Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, to qualifying SPEs.
2. The amendments would clarify that the objective of paragraph 9 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 transferred financial assets. This determination must consider all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer.
3. The amendments would define the term *participating interest* to establish specific conditions for reporting a transfer of a portion of a financial asset as a sale. If the transfer does not meet those conditions, sale accounting could be achieved only by transferring an entire financial asset or a group of financial assets that meet the derecognition criteria in paragraph 9 of Statement 140, as amended.
4. The special provisions in Statement 140 and FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, for guaranteed mortgage securitizations would be removed to require them to be treated the same as any other transfer of financial assets within the scope of Statement 140, as amended. If such a transfer does not meet the requirements for sale accounting, the securitized mortgage loans would continue to be classified as loans.
5. The use of fair value measurements would be increased because the proposed amendments would require a transferor's beneficial interests to be considered an asset obtained as proceeds that is initially measured at fair value when the transfer is accounted for as a sale. The amendments also would eliminate the fair value practicability exceptions in Statement 140.
6. Enhanced disclosures would be required to provide users of financial statements with greater transparency about transfers of financial assets and a transferor's continuing involvement with such transferred financial assets.<sup>28</sup>

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<sup>27</sup> Ed Zwirin, FASB to Tackle QSPEs, Market Media Online (December 16, 2008), [http://www.marketsmediaonline.com/news\\_details.htm?wP=11&wPI=1&cN=2536](http://www.marketsmediaonline.com/news_details.htm?wP=11&wPI=1&cN=2536).

<sup>28</sup> See Revised Exposure Draft for Proposed Statement for Financial Accounting Standards 140, [http://www.fasb.org/draft/ed\\_transfers\\_financial\\_assets\\_amend\\_st140.pdf](http://www.fasb.org/draft/ed_transfers_financial_assets_amend_st140.pdf).

The FASB received a total of 48 comments regarding the amendments to FAS 140.<sup>29</sup> Regarding comments related to QSPEs, there was a general feeling of support for the removal of the QSPEs;<sup>30</sup> however, there were also general concerns over the effect and effectiveness of such elimination.<sup>31</sup>

### III. FASB Board Decisions

At an April 1, 2009 Board Meeting, the FASB reached the following pertinent decisions during redeliberations of the 2008 Exposure Draft.<sup>32</sup>

I. FASB affirmed the following provisions of the Exposure Draft on accounting for transfers of financial assets:

- a. Removal of the concept of a qualifying-special purpose entity.
- b. The requirement that a transferor consider all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer.
- c. Implementation guidance on isolation.
- d. Removal of special provisions for guaranteed mortgage securitizations.
- e. The measurement of beneficial interests and participating interests in transfers accounted for as sales.
- f. The measurement and classification of interests (including security interests) in the transferred financial assets received by the transferor when a transfer does meet the criteria for sale accounting.

II. FASB affirmed the definition of participating interest with the following changes:

- a. Remove the proposed exception to participating interests for transfers of portions of equity instruments, derivative financial instruments, and hybrid financial instruments with an embedded derivative that is not clearly and closely related, as described in FASB Statement No.133, *Accounting for Derivative Instruments and Hedging Activities*.

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<sup>29</sup> Copies of recent Comment Letters to the Proposed Amendments to FAS-140 can be found at <http://www.fasb.org/ocl/fasb-getletters.php?project=1610-100>; A general summary of these Comment Letter can be found at [http://www.fasb.org/project/cl\\_summary\\_transfers\\_of\\_financial\\_assets.pdf](http://www.fasb.org/project/cl_summary_transfers_of_financial_assets.pdf).

<sup>30</sup> FASB, Transfers of Financial Assets Comment Letter Summary, [http://www.fasb.org/project/cl\\_summary\\_transfers\\_of\\_financial\\_assets.pdf](http://www.fasb.org/project/cl_summary_transfers_of_financial_assets.pdf).

<sup>31</sup> *Id.*

<sup>32</sup> FASB, [http://www.fasb.org/project/transfers\\_of\\_financial\\_assets.shtml#due\\_process](http://www.fasb.org/project/transfers_of_financial_assets.shtml#due_process) (the conclusions discussed herein were taken directly from the FASB website).

- b. Exclude from the determination of proportional cash flows the cash flows related to (1) the origination of financial assets, (2) effectuating the transfer of the financial assets, and (3) servicing the financial assets.
- c. Clarify that third-party guarantees should not be considered in the evaluation of whether the participating interest definition is met.
- d. Clarify that, in the event of bankruptcy or receivership of the transferor, set-off rights of the borrower do not preclude meeting the definition of a participating interest.
- e. Clarify that a financial instrument that is legally a single contract is considered an individual financial asset. For example, a loan transferred to a special purpose entity before securitization should be considered an individual financial asset. In addition, a beneficial interest (in the loan) issued after the securitization process has been completed should be considered an individual financial asset.
- f. Clarify that transfers of portions of a financial asset that do not individually qualify for sale accounting because they do not meet the participating interest definition, but result in the transferor transferring all of the interests in the original financial asset, should be derecognized when all portions of the financial asset have been transferred.

III. FASB also decided not to provide an exception to the definition of a participating interest for transfers in situations in which the transferor retains a non-prorata senior interest in the financial asset.

IV. FASB decided to retain the existing language in paragraph 9(b) of Statement 140, but to remove the notion of a qualifying special purpose entity from that paragraph. The Board decided to require look-through provisions to consider the abilities of the beneficial interest holders to pledge or exchange their beneficial interests when the transferee entity is a special purpose entity involved in a securitization or asset-backed financing arrangement.

V. FASB decided to amend Statement 140 to require that the application of paragraphs 9(b) and 9(c) consider the transferor's relationship with the transferred financial asset and any involvements with beneficial interest holders in securitized financial assets.

VI. FASB decided that a transferor should not account for the transfer of a financial asset as a sale if the transferor retains effective control over all or a portion of the transferred financial asset or group of financial assets being evaluated for derecognition as a single unit.

VII. FASB decided that a transferor must record a portion of a transferred financial asset as a purchase in certain cases in which a subsequent change to the portion causes the transferred portion to no longer meet the criteria of a participating interest (see paragraph 55 of Statement 140).

VIII. FASB redeliberated significant issues related to the disclosures required in the proposed amendment to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* and made the following decisions:

- a. The proposed disclosures would be updated to reflect the results of the Board's redeliberations of FSP FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*.
- b. The scope of the proposed sensitivity analysis disclosures would be finalized as proposed and would not be expanded.
- c. The Board previously decided to require specific disclosures for securitization and asset-backed financing arrangements where a transferor has continuing involvement with transferred financial assets accounted for as sales. The Board decided to expand those requirements to all transfers of financial assets accounted for as sales where the transferor has continuing involvement with transferred financial assets.
- d. All disclosure requirements would apply to both nonpublic and public entities.
- e. An entity would disclose the nature of any beneficial interests received as proceeds from a sale of financial assets, and also disclose the inputs and valuation techniques used to value those beneficial interests.
- f. An entity would disclose the maximum exposure to loss arising from its continuing involvement, except in the case of a secured borrowing.
- g. Further guidance on how to consider materiality or significance in relation to continuing involvements would not be provided.
- h. The reporting entity would not be required to disclose standardized categories of transferred financial assets in standardized tabular formats.
- i. An entity would not be required to disclose an analysis of the maturity of its repurchase obligations.
- j. An entity would not be required to disclose the amount of transfer activity (that qualifies for derecognition) in a reporting period when the transfer activity is not evenly distributed throughout the reporting period.

XIV. Finally, FASB has decided to deliberate at a future meeting issues related to transition guidance and effective date.

The final standards are set to be issued in June 2009. Generally, the approved standards will be effective as of the beginning of 2010 and will apply to existing entities, including existing qualifying special purpose entities. However, the amendments on how to account for transfers of financial assets will apply prospectively to transfers occurring on or after the effective date.<sup>33</sup>

#### IV. Conclusions

Since the fallout from the Enron scandal, FASB has been looking into amending FAS 140. As a result of the recent subprime mortgage crises, the FASB has been on a fast track to remove use of QSPEs as an acceptable accounting practice. The fact these new accounting standards have finally been adopted should not come as a surprise to banks and financial institutions.

But what do these new accounting standards mean for banks and other lending institutions? The rule change clearly would make it harder and costlier for banks and other lending institutions to package and sell off mortgage loans.<sup>34</sup> The QSPE, the vehicle which has allowed Banks to accomplish this, would no longer be a viable option. As a result, borrowing could become more expensive for consumers and companies.<sup>35</sup> Furthermore, banks will have to use other rules governing off-balance-sheet vehicles to account for them and these additional rules are currently and likely to be tightened as well.<sup>36</sup> As a result, this will likely provide additional work for CPAs. To put the impact of a change in perspective, “At the end of 2007, J.P. Morgan Chase & Co. and Citigroup Inc. had nearly \$1 trillion in assets held off their books in special securitization vehicles. J.P. Morgan generated nearly \$3.5 billion in revenue, or about 6% of total 2007 net revenue, from administering special securitization vehicles.”<sup>37</sup>

The other possible result of these amendments is that banks and other companies might be forced to bring billions of dollars worth of assets and liabilities back on their balance sheets, which in turn could trigger new capital requirements.<sup>38</sup> These additional capital requirements result from the regulatory requirement that banks hold a certain amount of capital in reserve to protect investors, and this reserve amount is based on the assets carried on the bank’s balance sheet.<sup>39</sup> As a result, more assets on the balance sheets would mean more reserves.

Of course the upside to these accounting changes is that they will hopefully prevent the abuses that have led to billions of dollars of losses over the past year.<sup>40</sup> These new accounting principles would hopefully increase transparency within lending institutions, as well as provide a

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<sup>33</sup> FASB, Briefing Document: FASB Statement 140 and FIN46(R), [http://www.fasb.org/news/051809\\_fas140\\_and\\_fin46r.shtml](http://www.fasb.org/news/051809_fas140_and_fin46r.shtml).

<sup>34</sup> David Reilly, FASB Signals Stricter Rules For Banks’ Loan Vehicles, The Wall Street Journal Online (May 2, 2008), [http://online.wsj.com/article\\_print/SB120969084241961495.html](http://online.wsj.com/article_print/SB120969084241961495.html).

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> Cormick Grimshaw, FASB’s new QSPE Rule Implementation Delayed, Market Pipeline (July 30, 2008), <http://marketpipeline.blogspot.com/2008/07/fasbs-new-qspe-rule-implementation.html> link]

<sup>39</sup> *Id.*

<sup>40</sup> David Reilly, FASB Signals Stricter Rules For Banks’ Loan Vehicles, The Wall Street Journal Online (May 2, 2008), [http://online.wsj.com/article\\_print/SB120969084241961495.html](http://online.wsj.com/article_print/SB120969084241961495.html).

more realistic portrayal of a lending institution's debt level, borrowing capacity and overall risk. Finally, they should allow third parties to better gauge the appropriate value of a company.

We will continue to monitor the implementation of these changes as well as the effect the new standards will have on the financial industry.

### **Important Links:**

1. FASB General Information regarding Amendment to FAS-140:  
[http://www.fasb.org/project/transfers\\_of\\_financial\\_assets.shtml#due\\_process](http://www.fasb.org/project/transfers_of_financial_assets.shtml#due_process)
2. Original FAS-140 Adopted in September 2000:  
<http://fasb.org/pdf/fas140.pdf>
3. Revised Exposure Draft for Proposed Amended to FAS-140:  
[http://www.fasb.org/draft/ed\\_transfers\\_financial\\_assets\\_amend\\_st140.pdf](http://www.fasb.org/draft/ed_transfers_financial_assets_amend_st140.pdf)
4. Comment Letters to the Proposed Amendments to FAS-140:  
<http://www.fasb.org/ocl/fasb-getletters.php?project=1610-100>
5. General summary of Comment Letters to the Proposed Amendments to FAS-140:  
[http://www.fasb.org/project/cl\\_summary\\_transfers\\_of\\_financial\\_assets.pdf](http://www.fasb.org/project/cl_summary_transfers_of_financial_assets.pdf).