Financial Instruments and Credit Group
Capital Markets Accounting Developments Advisory

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Analysis of Proposed ASU Topic 860 – Transfers and Servicing: Reconsideration of Effective Control for Repurchase Agreements

Overview

On November 3, 2010, the FASB issued Proposed Accounting Standards Update, *Reconsideration of Effective Control for Repurchase Agreements* (the "proposed ASU"). The objective of the proposed ASU is to improve the accounting for repurchase agreements (a "repo") and other similar agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their stated maturity.

In a typical repo, transferor transfers financial assets and has an agreement with the transferee to repurchase the same or substantially the same financial assets for a fixed price in the future.

The proposed guidance would modify the transferor's assessment of whether a transferor maintains effective control over transferred financial assets. Under current guidance, this assessment includes a determination of the sufficiency of collateral for a repo transaction at inception and over its term.

The proposed guidance would make the sufficiency of collateral irrelevant to the accounting treatment for the transfer of financial assets. The proposed guidance is expected to expand the number and types of transactions that are accounted for as secured borrowings.

This Capital Markets Accounting Developments Advisory ("CMADA") describes the proposed change and its potential impact on current practice by discussing the proposed ASU and its impact on US GAAP. It also discusses how the changes affect convergence with International Financial Reporting Standards ("IFRS").

***FSR observation**: On September 17, 2010, the SEC proposed enhancements to the disclosures companies provide about their short-term borrowings. The proposal would require companies to provide comprehensive qualitative and quantitative disclosures around their short-term borrowings in the management's discussion and analysis section of their SEC filings.*

The proposed rules did not include an effective date. The SEC has stated that the proposed rules will not be required for calendar year end companies in 2010. Companies should consider gathering the required the information as of the beginning of the next reporting period to prepare for the new requirements.

Under the proposal, the definition of "short-term borrowings" would include certain repos and other similar agreements. The proposed disclosures would include a general description and the business purpose of the borrowings, their importance to the company, reasons and context around the maximum amount for the reporting period, and any reasons for any material differences between the average and period-end short-term borrowings.

The proposed disclosures for the maximum amount are defined differently for financial service companies and non-financial service companies, with financial service companies required to make more detailed disclosures.

How the proposed ASU would change US GAAP

Current GAAP

As prescribed in the Accounting Standards Codification Topic 860, *Transfers and Servicing* ("ASC 860"), transfers of financial assets are accounted for as a secured borrowing when a transferor maintains effective control over the transferred financial assets.

ASC 860-10-40-24(b) defines the transferor's ability criterion as being met when the transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee.

The assessment of whether a transferor is able to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee, requires a transferor to have, at all times during the contract term, cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement financial assets from others.

If the transferor does not maintain the power to ensure sufficient collateral at all times, then the transferor may not maintain effective control over the transferred financial assets.

The criterion in ASC 860-10-24(b) is satisfied when the transferor receives sufficient collateral from the borrower to fund substantially all of the purchase of replacement assets during the term of the contract if the borrower does not perform under the agreement.

Proposed change in GAAP

The proposed ASU would remove the level of collateral received and the transferee's ability to perform on its obligation from the assessment of whether a transferor maintains effective control over transferred financial assets.

The other criteria assessed to determine whether a transferor maintains effective control over transferred financial assets are not amended. Specifically, the transaction terms must ensure that the:

1) Financial assets to be repurchased or redeemed are the same or substantially the same as those transferred,

2) Agreement is to repurchase or redeem them before maturity, at a fixed or determinable price, and

3) Agreement is entered into contemporaneously with, or in contemplation of, the transfer.

FSR observation: *The FASB believes that solely a transferor's contractual rights and obligations would determine effective control. The level of cash collateral received by the transferor in a repo or other similar agreement would no longer be relevant in determining whether a transfer of financial assets should be accounted for as a sale or a secured borrowing.*

The proposed ASU will likely result in more repos and other similar agreements being accounted for as financings.

How the changes affect convergence with IFRS

Under IAS 39, *Financial Instruments: Recognition and Measurement*, repurchase agreements typically fail sale accounting because the risks and rewards of the transferred asset are retained by the transferor. Therefore, the proposed ASU would make US GAAP more consistent with current IFRS, albeit for different reasons.

The IASB had a project on its agenda to revisit the derecognition model in IAS 39, which may have impacted the assessment for repurchase agreements. However, this project has been put on hold given the numerous high profile projects already on the plates of both the FASB and IASB.

Who's affected and what's next?

The proposed ASU would apply to both public and non-public companies that have repos (or reverse repos) or other similar agreements such as share lending transactions. The comment period ends on January 15, 2011.

Subsequent to the comment period, a final ASU is expected to be issued during the first quarter of 2011. The final ASU is expected to be effective prospectively for new transfers and existing transactions that are modified at the beginning of the first interim or annual period after the final ASU is issued.

Questions regarding this advisory may be directed to:

David Lukach	+1 646 471 3150
Fred Elmy	+1 646 471 2830
Frank Gaetano	+1 646 471 1356
Susan Cosper	+1 646 471 5829
Jeff Allen	+ 1 646 471 2937
Neal Dykes	+ 1 646 471 2359
Jacob Sperry	+1 646 471 5069
Ross Drucker	+ 1 646 471 5947

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