

Hot Topic

Update on major accounting
and auditing activities

FASB issues Statement 166, an amendment to Statement 140

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Overview

On 12 June 2009, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 166, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140* (Statement 166). Statement 166, which was exposed for comment in September 2008, is in response to the FASB's concerns about how practice has developed under FASB Statement No. 140, *Accounting for Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Statement 140), as well as concerns expressed by constituents that certain transfers of financial assets should not qualify as sales under Statement 140.

The most significant amendments resulting from Statement 166 consist of the removal of the concept of a qualifying special-purpose entity (SPE) from Statement 140, and the elimination of the exception for qualifying SPEs from the consolidation guidance of FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* (FIN 46(R)).

In addition, Statement 166:

- ▶ Amends and clarifies the unit of account eligible for sale accounting as:
 - ▶ an entire financial asset,

- ▶ a group of entire financial assets, or
- ▶ a *participating interest*, as defined, in an entire financial asset
- ▶ Requires that a transferor recognize and initially measure at fair value all assets obtained (e.g. a transferor's beneficial interest) and liabilities incurred as a result of a transfer of an entire financial asset or group of entire financial assets accounted for as a sale
- ▶ Consistent with the preceding bullet, eliminates the practicability exception for the measurement at fair value of assets obtained (i.e., proceeds) and liabilities incurred by a transferor in a transfer that meets the conditions for sale accounting
- ▶ Removes the special provisions in Statement 140 and FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, for guaranteed mortgage securitizations
- ▶ Clarifies that an entity must consider all arrangements or agreements made contemporaneously with, or in contemplation of, a transfer when applying the derecognition criteria of Statement 140, as amended by Statement 166

- ▶ Clarifies the requirements of the legal isolation analysis
- ▶ Requires a transferor to “look through” a securitization vehicle and consider the abilities of the beneficial interest holders to pledge or exchange their beneficial interests
- ▶ Clarifies the principle in the effective control criteria of Statement 140 that the transferor must evaluate whether it, its consolidated affiliates included in the financial statements being presented, or its agents effectively control the transferred financial asset(s) directly or indirectly
- ▶ Requires enhanced disclosures about, among other things, a transferor’s continuing involvement with transfers of financial assets accounted for as sales, the risks inherent in the transferred financial assets that have been retained, and the nature and financial effect of restrictions on the transferor’s assets that continue to be reported in the statement of financial position

Each of these key amendments to Statement 140 is discussed further below.

Concurrent with the issuance of Statement 166, the FASB issued FASB Statement 167, *Amendments to FASB Interpretation No. 46(R)* (Statement 167). This project was undertaken by the FASB to address the effect of eliminating the qualifying SPE concept from Statement 140 and to respond to concerns about the application of certain key provisions of FIN 46(R), including concerns over the transparency of an enterprise’s involvement in a variable interest entity (VIE).

Statement 167’s amendments to FIN 46(R) change how an enterprise determines if it must consolidate a VIE. The new standard requires an enterprise to perform a qualitative analysis when determining whether it must consolidate a VIE. Under Statement 167, if an enterprise has an interest in a VIE that provides it with power to direct the activities of the VIE that most significantly impact the entity’s economic performance (and the obligation to absorb

losses or the right to receive benefits that could potentially be significant), an enterprise must consolidate the VIE. In addition, Statement 167 requires an enterprise to update its primary beneficiary analysis on an ongoing basis and to provide additional disclosures about its involvement with a VIE and any significant changes in risk exposure due to that involvement.

Refer to our Hot Topic, *FASB issues Statement 167, an amendment to FIN 46(R)* (HT No. 2009-22), which further discusses these amendments to FIN 46(R).

Background

The road to Statement 166 and its amendments of Statement 140 has been a long one. 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 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 three different Exposure Drafts over the past six years.

The first of these Exposure Drafts was issued in June 2003, which among other things, was intended to deal with issues related to qualifying SPEs and isolation of

transferred assets. This exposure draft and a revised Exposure Draft issued in August 2005 received a significant amount of constituent feedback and were the subject of extensive redeliberation by the FASB. As a result, a third Exposure Draft was issued in September 2008. With this third Exposure Draft, the FASB also decided that it was necessary to reevaluate the conditions for derecognition in Statement 140 and to clarify the guidance about what types of continuing involvement do or do not indicate that a transferor continues to control transferred financial assets.

Statement 166 is the result of deliberations on the feedback received on the 2005 and 2008 Exposure Drafts on accounting for transfers of financial assets, continued constituent inquiries (including financial statement user requests for greater transparency), and market conditions over the past three years including, but not limited to, the impact of the recent credit crisis.

Significant amendments

Removal of the qualifying SPE concept

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 conditions for a qualifying SPE 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 current FASB has indicated it believes that, in practice, the conditions for a qualifying SPE are being applied more broadly than its predecessors 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 what it believes is the spirit of Statement 140. As a result, and after much consideration, the FASB decided to remove the concept of a qualifying SPE from

Statement 140. As a result, the FASB also eliminated the qualifying SPE scope exception from FIN 46(R), which will result in many current qualifying SPEs being consolidated by the sponsor or transferor.

Transfers of portions of financial assets

Statement 166 amends and clarifies the unit of account to which the derecognition conditions must be applied. Statement 166 requires the derecognition criteria to be applied to transfers of an entire financial asset, transfers of groups of entire financial assets, and transfers of participating interests (as defined) in an entire financial asset. Inherent in this requirement is that an individual financial asset cannot be divided into components prior to a transfer unless all of the components meet the definition of a participating interest.

Generally, Statement 166 defines a participating interest as a financial asset that possesses each of the following characteristics:

- ▶ It represents a proportionate (pro rata) ownership interest in an entire financial asset
- ▶ It entitles each participating interest holder to all of the cash flows received from an entire financial asset in proportion to their share of ownership. However, cash flows allocated as compensation for services performed are not included in that determination provided certain conditions are met
- ▶ It requires that each participating interest holder have the same priority and no participating interest holder is subordinated to another—that is, it involves no recourse to, or subordination by, any participating interest holder and it 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 also meet the conditions for surrender of control in Statement 140, as amended by Statement 166.

Measurement of a transferor's beneficial interest

Prior to the amendments of Statement 166, Statement 140 required that beneficial interests held by a transferor be measured by allocating the carrying amount of the transferred financial assets between the financial assets transferred and the financial assets retained based on their relative fair values at the time of the transfer. The FASB had concluded in Statement 140 that even though beneficial interests in transferred financial assets are different from the original financial assets, surrender of control has not occurred for the retained beneficial interests because those interests never left the possession of the transferor. However, this principle did not apply to other assets obtained in transactions accounted for as sales even though the assets obtained often related to the transferred financial assets (e.g., servicing assets).

After the FASB decided to require that Statement 140's conditions for sale accounting only be applied to transfers of an entire financial asset, transfers of groups of entire financial assets, and transfers of a participating interest in an entire financial asset, the FASB reconsidered the nature of a transferor's beneficial interest in a transferred financial asset. Consequently, Statement 166 requires any beneficial interest or other asset obtained in a transfer accounted for as a sale should be considered proceeds from the sale and, thus, warrants initial measurement of all assets obtained and liabilities incurred at fair value.

Elimination of the fair value practicability exception

Prior to Statement 166, the FASB concluded that if it is not practicable to estimate the fair values for assets obtained and liabilities incurred in sales with continuing

involvement, assets should be measured at zero and liabilities at the greater of:

- ▶ the amount called for under FASB Statement No. 5, *Accounting for Contingencies*, as interpreted by FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, or
- ▶ the excess, if any, of (a) the fair value of the assets obtained less the fair value of the other liabilities incurred over (b) the sum of the carrying values of the assets transferred.

The above requirement for liability measurement was intended to prevent recognition of gains by underestimating liabilities.

As discussed in the basis for conclusions in Statement 157, the FASB decided to retain the practicability exceptions for fair value measurements in certain accounting pronouncements within the scope of that Statement, including the exception provided in Statement 140. However, during the redeliberations on the proposed amendments to Statement 140, the FASB reconsidered the original basis for the practicability exception in that Statement. The FASB concluded that the concerns that led to the exception in Statement 140 were addressed with the issuance of Statement 157. Additionally, the FASB observed that the requirements for being able to apply the practicability exception were rarely met in practice. Accordingly, Statement 166 removes the fair value practicability exception in Statement 140 in its entirety.

Removal of the exception for guaranteed mortgage securitizations

FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, as amended by FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (Statement 115) requires that, after the securitization of a mortgage loan held for sale, any retained mortgage-backed securities be classified in accordance with the provisions of Statement 115, even when the transferor

holds all of the resulting securities. Statement 140, as amended by FASB Statement No. 156, *Accounting for Servicing of Financial Assets*, 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 (regardless of whether the transfer meets the requirements for sale accounting) and retains all of the resulting securities and classifies those securities as either available for sale or trading securities.

The FASB questioned whether it was appropriate to reclassify a financial asset from a loan to a security when a transferor holds all of the resulting securities and has not met the requirements for sale accounting. Accordingly, the Board decided to eliminate 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.

Legal isolation of transferred assets

Statement 140 includes a requirement that, except for certain bankruptcy-remote entities, transferred financial assets must be isolated from any entity in the transferor's consolidated group. Because of questions and inconsistencies in the application of this provision in practice, the FASB decided to clarify the requirements for isolation by bringing-forward guidance that previously existed in the implementation guidance and basis for conclusion to Statement 140, and by incorporating some of the guidance in AU Section 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336*. In so doing, Statement 166 clarified:

- ▶ 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 determination whether financial assets are isolated must consider all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer.

Statement 166 also provides additional guidance on the nature of the legal opinions often required to support a conclusion that a "true-sale" has occurred.

Constraints on transferability

In the 2008 Exposure Draft, the FASB proposed that a constraint on the ability of the transferee to pledge or exchange its assets indicates that a transferor maintains effective control over a transferred asset "unless such constraint is designed primarily to provide the transferee with a benefit." Most of the respondents to the 2008 Exposure Draft stated this criterion was not clear or operational or was overly subjective. The FASB decided to retain the existing ability to "pledge or exchange" criterion (with modification for the removal of the qualifying SPE concept) and to clarify when a transferor should look through to the third-party beneficial interest holders, rather than look to the transferee, in evaluating this criterion.

The FASB realized that in cases in which a financial asset is transferred to a securitization entity, a constraint on the ability of the transferee to sell or exchange its assets is usually, but not always, necessary if the transferee intends to issue beneficial interests. Therefore, the FASB concluded that such a constraint would not indicate that the transferor has maintained effective control over the transferred asset.

In these instances, Statement 166 amends the ability to "pledge or exchange" criterion and requires the transferor to look through to the beneficial interest holders, rather than look to the transferee, in evaluating the transferee's ability to pledge or exchange. That is, in cases in which (a) a financial asset is transferred to an entity whose sole purpose is to facilitate a securitization or asset-backed

financing and (b) the transferee entity is constrained from pledging or exchanging the asset it receives, the transferor should evaluate whether the beneficial interest holders have the ability to pledge or exchange their beneficial interests.

However, in all other cases, a constraint on the ability of the transferee to sell or exchange its assets may indicate that the transferor has maintained effective control and, therefore, the transferor would be precluded from derecognizing the transferred financial assets.

Effective control

One of the requirements for sale accounting is that the transferor must not maintain effective control over the transferred financial assets through a unilateral ability to reclaim the transferred assets. Statement 140 and its implementation guidance currently address specific arrangements and have resulted in numerous requests to clarify whether other arrangements result in the transferor maintaining effective control.

During the FASB's deliberations of the proposed amendments to Statement 140, the FASB decided that it was not feasible to provide specific guidance on all of the possible arrangements that could be made between the various parties to a transfer of financial assets. As a result, the FASB decided to clarify that the transferor should evaluate whether it has maintained effective control by considering any continuing involvement through direct involvements with the transferred financial assets. That guidance clarifies that the transferor should evaluate whether the transferor, its consolidated affiliates included in the financial statement being presented, and its agents maintain effective control by considering, among other things, any direct continuing involvement with the transferred financial assets.

Statement 166 also requires a transferor to consider its indirect continuing involvement with the transferred financial assets that could enable it to maintain effective control over those assets through an arrangement

made with beneficial interest holders of the transferred financial assets. An example of continuing involvement that provides the transferor with effective control over the transferred financial asset includes a call on a transferred financial asset or the third party beneficial interests related to the transferred asset that, under its price and other terms, provides the transferor with:

- ▶ the unilateral ability to reclaim the transferred financial asset and
- ▶ more than a trivial benefit

With respect to the second criterion, a call option would convey more than a trivial benefit if the price to be paid is fixed, determinable, or otherwise potentially advantageous (unless, because that price is so far out of the money or for other reasons, it is probable when the option is written that the transferor will not exercise it).

Disclosures

In developing the incremental disclosures included in Statement 166, the FASB noted that existing US GAAP already requires numerous disclosures related to transfers of financial assets, risks and uncertainties, credit concentrations, derivatives, and assets measured at fair value. However, the FASB concluded that some of these disclosures could be enhanced and incorporated directly into Statement 140 to provide greater transparency about transfers of financial assets and an entity's continuing involvement in transferred financial assets.

The disclosures required by Statement 166 are similar to those included in FASB Staff Position FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets* (FSP FAS 140-4/FIN 46(R)), which is superseded by Statement 166.

Effective date and transition

Statement 166 is effective as of the beginning of each reporting entity's first annual reporting period that begins after 15 November 2009, for interim periods within that first annual reporting period and for

interim and annual reporting periods thereafter. That is, Statement 166 is effective 1 January 2010 for calendar-year reporting entities. Earlier application is prohibited. The recognition and measurement provisions of Statement 166 are effective for transfers occurring on or after the effective date.

Additionally, on and after the effective date, existing qualifying SPEs must be evaluated for consolidation by reporting entities in accordance with the applicable consolidation guidance. If the evaluation on the effective date results in consolidation, the reporting entity must apply the transition guidance provided in the pronouncement that requires consolidation (e.g., Statement 167).

The disclosures required by Statement 166 are effective for the first reporting period (interim or annual) beginning after 15 November 2009, and will be applied to both transfers that occurred before and after the effective date of Statement 166. The disclosures will apply for each annual and interim reporting period thereafter. An entity is encouraged, but not required, to disclose comparative information for periods earlier than the effective date for disclosures that were not previously required by Statement 140 for nonpublic entities, or by FSP FAS 140-4/FIN 46(R)-8 for public entities. In periods after initial adoption, comparative disclosures for those disclosures that were not previously required by Statement 140 for nonpublic entities, or by FSP FAS 140-4/FIN 46(R)-8 for public entities, are required only for periods after the effective date.

Potential effects

Statement 166 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 generally are not required to 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. With the removal of the concept of a qualifying SPE 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 they will obtain the necessary financial information for the newly consolidated SPEs and how this might affect relevant financial ratios, debt covenants or regulatory capital requirements, where applicable.

The conditions established in Statement 166 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. Consequently, in order for those transfers to receive sale treatment under the new derecognition model, 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.

In certain transactions, the transferor is entitled to repurchase a transferred amortizing, individual (specific) financial asset when its remaining principal balance reaches some specified amount, for example 40% of the original balance. To exercise that call, the transferor would pay the remaining principal balance. Under Statement 140 such a transfer would be accounted for as a part sale and part secured borrowing because the FASB reasoned that the fixed price call allows the transferor to maintain effective control only over the portion of the transferred assets subject to that call (i.e., the 40%). Under Statement 166, such a transaction would be accounted for entirely as a secured borrowing because permitting partial sale/partial secured borrowing treatment would be inconsistent with the definition of a participating interest.

Prior to Statement 166, portions of financial assets were typically sold with a stipulated interest factor based on market interest rates at the time of sale. Going forward, to qualify as a participating interest, Statement

166 requires that all cash flows (e.g., both contractual principal and interest payments) received from an entire financial asset be divided among the participating interest holders in proportion to their share of ownership. Because a participating interest in an asset may be sold after the purchase or origination of the asset, often the contractual interest rate passed through for the portion of the asset transferred will differ from market interest rates at the time of sale of the participating interest. In instances in which the transferor desires a sale of a participating interest, differences between contractual and market interest rates at the time of sale will likely result in portions of financial assets being sold at either discounts or premiums to the face amount of the participating interest. These purchase discounts or premiums will expose investors to additional prepayment risks.

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

Statement 166 will significantly affect securitization practices and accounting for transfers of financial assets. Entities should begin to assess the effect of these amendments on their transfers as soon as possible. We will issue additional implementation guidance in the near future.

Convergence with IFRS

Statement 166's removal of the special provisions in Statement 140 for guaranteed mortgage securitizations and the removal of the concept of a qualifying SPE, including the exceptions from applying the consolidation guidance of FIN 46 (R) to qualifying SPEs, help bring US GAAP closer to IFRS. These special accounting provisions and exceptions previously afforded to guaranteed mortgage securitizations and qualifying SPEs under Statement 140 do not exist in the comparable accounting standards of International Financial Reporting Standards (IFRS)—that is, International Accounting Standard 39, *Financial Instruments: Recognition and Measurement* (IAS 39), or the International Accounting Standards Committee's (IASC) Standing Interpretations Committee 12 *Consolidation—Special Purpose Entities* (SIC 12).

Convergence between both sets of accounting standards may also be helped with recent proposals to IFRS' accounting model for transfers of financial instruments. On 31 March 2009, the International Accounting Standards Board (IASB) published for public comment an exposure draft of proposals to improve the derecognition requirements for financial instruments. The IASB believes its proposed approach is similar in some respects to Statement 166. Like Statement 166, the proposed approach under IFRS assesses derecognition on the basis of control, and evaluates control in a somewhat similar manner. A major difference between the derecognition requirements of Statement 166 and the proposed approach in the IAS exposure draft is that Statements 140 and 166 require that transferred financial assets have been isolated from the transferor, any of its consolidated affiliates and its creditors, even in bankruptcy, to achieve sale accounting. The approach proposed in the IAS exposure draft does not require such a legal isolation test.

A final amendment of the IAS 39 derecognition guidance is expected to be issued sometime during 2010.

Additionally, now that the FASB has completed its short-term amendments to Statement 140, the two Boards have committed to work jointly and expeditiously to ultimately issue a converged derecognition standard.

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