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The amendments propose to eliminate the collateral maintenance provision that a company uses to determine whether a transfer of financial assets in a repo transaction is accounted for as a sale or as a secured borrowing.

Repo 101: FASB Gets Back to Basics on Repurchase Accounting

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On November 3, 2010, the FASB issued a proposed ASU[1] that amends the guidance in ASC 860[2] on accounting for certain repurchase agreements ("repos"). Specifically, the amendments propose to eliminate the collateral maintenance provision that a company uses to determine whether a transfer of financial assets in a repo transaction is accounted for as a sale or as a secured borrowing. The elimination of the collateral maintenance provision from a company's assessment of effective control over transferred financial assets in a repo may cause more repos to be accounted for as secured borrowings rather than as sales. The details of the proposed changes are discussed below.

The proposed ASU would be effective for interim and annual periods beginning after the final ASU is issued (expected in the first quarter of 2011) and would be applied prospectively to new transfers and existing transactions that are modified after the effective date. Early adoption would be prohibited. Comments on the proposed ASU are due by January 15, 2011.

Editor's Note: The proposed ASU comes on the heels of the SEC's recently proposed rule[3] that addresses temporary declines in short-term borrowings — usually around period-end — commonly referred to as "window dressing." The proposed rule would require registrants to disclose more information about their short-term borrowing arrangements, including repurchase agreements, and would therefore help investors better understand a registrant's financings during a period as well as at period-end. For more information about the SEC's proposed rule, see Deloitte's September 24, 2010, *Heads Up*.

Background

In one form of repo, the company transfers financial assets to a purchaser and receives cash and promises to repurchase the same (or substantially the same) financial assets on a future date and at a specified price. In essence, the company "borrows" cash equal to the sales price of the financial assets and has the obligation to return that cash (i.e., repurchase the financial asset) on a future date. The difference between the initial sales price and the specified repurchase price represents interest expense for the company for the use of funds. In these transactions, the financial assets held by the purchaser effectively "collateralize" the company's debt (i.e., the obligation to repurchase the financial assets in the future). Whether to account for such a transaction as a sale or a secured borrowing depends on whether the company meets certain criteria in ASC 860.

Under ASC 860, a company that maintains effective control over transferred financial assets must account for the transfer as a secured borrowing rather than as a sale. Further, ASC 860 states that a company maintains effective control in a repo if certain criteria are met. One of these criteria indicates that a company maintains effective control over a

[1] FASB Proposed Accounting Standards Update, *Reconsideration of Effective Control for Repurchase Agreements*.
[2] FASB Accounting Standards Codification Topic 860, *Transfers and Servicing*.
[3] SEC Proposed Rule Release No. 33-9143, *Short-Term Borrowings Disclosure*.

financial asset when the transferor "is able to repurchase or redeem [the financial asset] on substantially the agreed terms, even in the event of default by the transferee." To comply with this criterion, the company must maintain cash or sufficient collateral "to fund substantially all of the cost of purchasing replacement financial assets from others." A company that meets this criterion maintains effective control over the transferred financial assets and must account for the transfer as a secured borrowing. A company that does not meet this criterion may need to account for the transfer of financial assets as a sale depending on whether it meets other criteria in ASC 860.

The Proposed Changes

In the aftermath of the global credit crisis, many capital market participants questioned whether the **ability** to repurchase or redeem and the related collateral maintenance provisions (collectively, "the collateral maintenance provision") were relevant to a company's assessment of effective control over transferred financial assets in repos. Said another way, capital market participants questioned whether the accounting for a repo should depend on the level at which the company collateralizes the transferred financial assets. To answer this question, the FASB reconsidered the criteria for whether a company has maintained effective control over transferred financial assets in repos and determined that the collateral maintenance provision should not be determinative of effective control. In other words, the assessment of effective control should focus on a transferor's **contractual rights and obligations** with respect to transferred financial assets, not on whether the transferor has the practical ability to exercise those rights or honor those obligations. Accordingly, the proposed ASU removes the collateral maintenance provision (and the related implementation guidance) from ASC 860. The outcome of removing this provision is that more repos may be accounted for as secured borrowings rather than as sales.

The FASB reconsidered the criteria for whether a company has maintained effective control over transferred financial assets in repos and determined that the collateral maintenance provision should not be determinative of effective control.

The removal of the collateral maintenance provision does not affect a transferor's evaluation of the other criteria for whether effective control over transferred financial assets has been maintained. The transferor must still evaluate all other criteria in ASC 860 regarding the transferor's effective control in a repo.[4]

Effective Date and Transition

The amendments would be effective for interim and annual periods beginning after issuance of the final ASU, which is expected in the first quarter of 2011, and would be applied prospectively to new transfers and existing transactions that are modified after the effective date. Early adoption would be prohibited.

Editor's Note: Because most repos are short term, the proposed ASU would grandfather repos entered into before the effective date of the final ASU. A company would continue to apply ASC 860 to such transactions (i.e., the company would continue to consider the collateral maintenance provision in evaluating effective control over transferred financial assets in a repo).

[4] See ASC 860-10-40-24 for the additional criteria that a company must meet for the company to maintain effective control over the transferred financial assets in a repo.

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