



**To:** Board Members

**From:** Beneficial Interests Team (Hamilton, ext. 330)

**Subject:** Minutes of the June 16, 2004 Board Meeting                      **Date:** June 22, 2004

**cc:** Bielstein, L. Smith, Petrone, Wilkins, Lott, E. Smith, Laurenzano, Hamilton, Thompson, Gabriele, Sutay, FASB Intranet

Topics: Accounting for Beneficial Interests in Securitized Financial Assets

Basis for Discussion: Board memorandum dated June 4 and Board memorandum supplement dated June 11.

Length of Discussion: 10:00 p.m. to 10:40 a.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, Trott

IASB Board/Staff present: Leisenring

Board members absent: None

Staff in charge of topics: E. Smith

Other Staff at Board table: L. Smith, Wilkins, Lott, Laurenzano, Hamilton

Outside Participants: None

### Summary of Decisions Reached:

The Board decided that all retained interests, including servicing rights, from transfers of financial assets accounted for as sales should be initially measured at fair value rather than based on an allocation of the previous carrying amount between the assets sold and the retained interests based on their relative fair values.

The Board clarified the intent of a decision made at the May 19 Board meeting relating to the beneficial interests in securitized financial assets project. The Board's intent was that *beneficial interests in transfers of financial assets accounted for as sales* should be allowed the fair value accounting option and accounted for at the holder's election:

1. At fair value with changes recognized in earnings, or
2. Through the application of existing accounting literature with additional guidance to be provided as to how embedded derivatives would be identified.

The reference to existing accounting literature, in the above decision at the May 19 Board meeting, excludes the guidance in **Statement 133 Implementation Issue No. D1**, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," which the Board has decided will be superseded by this decision.

### Objective of the Meeting:

The objectives of the meeting were to:

1. Clarify whether it was the Board's intent at the May 19 Board meeting that all beneficial interests be allowed the fair value accounting option, or only those beneficial interests that contain an embedded derivative that would otherwise need to be accounted for separately under paragraph 12 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

2. Determine the appropriate initial measurement attribute for beneficial interests.

Matters Discussed:

**Clarification of May 19 Board Decision**

Mr. E. Smith asked the Board to clarify a decision made at the May 19 Board meeting relating to the beneficial interests project. At issue was whether it was the Board's intent that the application of the fair value option be allowed for all beneficial interests in transfers of financial assets accounted for as sales (broad interpretation) or whether only beneficial interests that contain an embedded derivative that would otherwise need to be accounted for separately under paragraph 12 of Statement 133—a bifurcatable embedded derivative—would be allowed the fair value accounting option (narrow interpretation).

Mr. E. Smith stated that the staff's recommendation is intended to apply to all beneficial interests in transfers of financial assets accounted for as sales regardless of whether embedded derivatives were present. One reason the staff recommended the broad interpretation was to eliminate the need for an evaluation of whether embedded derivatives existed in beneficial interests for those entities willing to account for the entire interest at fair value. A broad interpretation of the fair value option would reduce the burden of evaluating and identifying embedded derivatives for entities willing to classify such interests at fair value.

Mr. Trott stated that, while he believes the decision made at the May 19 Board meeting was based only on beneficial interests that contain bifurcatable embedded derivatives, he believes that applying the decision to all beneficial interests in transfers of financial assets accounted for as sales would simplify current accounting guidance.

Ms. Seidman stated that she believes the Board's decision at the May 19 meeting was inclusive of only beneficial interests that contain bifurcatable embedded derivatives. She believes that the primary purpose of the beneficial interests in securitized financial assets project is to replace interim guidance in Implementation Issue D1 that exempts beneficial interests from being subject to Statement 133.

Messrs. Crooch and Schieneman, and Ms. Schipper believe that the Board's decision at the May 19 meeting was inclusive of all beneficial interests in transfers of financial assets accounted for as sales (broad interpretation). Mr. Crooch inquired as to any downside of broadening the scope. Ms. Seidman responded that the Board has a separate project to provide a fair value option. That project will evaluate whether any criteria should be required to qualify (including a measurement mismatch, a reliability threshold, etc.). Since some forms of beneficial interests are not in the form of securities (and therefore are not eligible for the trading account under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*), granting a broad election now could conflict with any conditions the Board ultimately decides to require in the fair value option project.

Mr. Batavick believes the Board's decision at the May 19 meeting was inclusive of only beneficial interests that contain bifurcatable embedded derivatives. He expressed concern that including all beneficial interests in the May 19 decision could result in unintended accounting consequences.

Mr. Herz stated that, while he originally interpreted the Board's May 19 decision to include only beneficial interests that contain bifurcatable embedded derivatives, he would not object to allowing the elective fair value option for all beneficial interests in transfers of financial assets accounted for as sales.

Mr. Herz asked if any Board members objected to clarifying that the Board's decision at the May 19 meeting applied to all beneficial interests in transfers of financial assets accounted for as sales. The Board approved this clarification. [Six Board members agreed; one objected: Seidman.]

### **Initial Measurement of Retained Beneficial Interests**

Mr. E. Smith introduced the second issue, initial measurement of retained beneficial interests in transfers of financial assets accounted for as sales. Paragraph 58 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, states that:

[Retained interests] shall be measured at the date of the transfer by allocating the previous carrying amount between the assets

sold, if any, and the retained interests, based on their relative fair values.

Mr. E. Smith noted that the Board accepted the carryover basis measurement for retained interests when it approved FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and then again in approving Statement 140. He also noted that a dissenting view was presented in Statements 125 and 140 and the dissenting view argued that a securitization is a remeasurement event and that beneficial interests in a securitization should be initially measured at fair value and that beneficial interests in securitized financial assets cannot be “retained” because the form of the assets (liabilities) received is different than the assets (liabilities) securitized.

Mr. E. Smith stated that the staff recommends that retained beneficial interests be initially measured at fair value based in part on the belief that:

- Assets obtained by the transferor in a securitization are new assets in that they are sufficiently different from the original assets.
- An event has occurred that warrants derecognition of 100 percent of the original assets and initial recognition of assets obtained by the transferor.
- Gains or losses should be recognized when such events occur.
- The recommendation is consistent with the Board’s assertion that fair value yields more useful and relevant information about financial instruments.

Mr. E. Smith commented that the staff is aware of potential pitfalls of initial fair value measurement of retained beneficial interests, where gains are recognized by the transactor, including:

- A securitization where a substantial percentage (90 percent) of the beneficial interests in the securitized assets are held by the transactor and only a small percentage (10 percent) are distributed.
- When available-for-sale securities are securitized in order to circumvent restrictions on reclassification between available-for-sale and trading securities in Statement 115 in order to immediately recognize gains (or losses).

Mr. E. Smith stated that he believes requiring initial fair value measurement of retained beneficial interests would result in revisions to at least 19 paragraphs in Statement 140.

Ms. Seidman stated that she does not believe the scope of this project should include remeasuring retained interests at fair value. She said that implementing that approach would have the effect of recognizing 100 percent of the gain or loss on the transferred assets, regardless of whether the transaction was only a partial sale. She views that result as inconsistent with the control principle underlying paragraphs 265–275 of Statement 140 and believes that it could produce undesirable accounting results.

Ms. Seidman also objected to the staff's recommendation on the grounds that she believes the recommendation would require a change to the provision in paragraph 9 of Statement 140 that a transfer of financial assets be accounted for as a sale only to the extent that consideration other than beneficial interests is received in the exchange. She stated that if the staff recommendation were accepted, the Board would have to determine how to characterize gains and losses associated with a securitization and whether gains and losses would be recognized differently depending on whether they were related to retained or purchased beneficial interests. She also believes that all of the examples in Statement 140, the definition of proceeds, and several Q&A's would have to be altered if the staff recommendation is accepted.

Mr. Lott stated that amending paragraph 9 of Statement 140 was only one way in which the Board's decision could be implemented. Another, simpler way, would be to amend paragraphs 10 and 11 of Statement 140 to apply fair value measurement to all of a transferor's interests whether retained or received in an exchange and not to make a distinction between interests retained and interests received in the exchange. There is precedence in existing GAAP for remeasuring financial assets at fair value (for example, Statement 115).

Ms. Seidman stated that there are a number of specific practice issues that involve transactions where there are different accounting standards being applied to the instruments being securitized, some of which were brought to the EITF by the SEC (for example, Statement 140 Q&A numbers 60–63). She cautioned that

the Board could face substantial implementation challenges if it accepts the staff recommendation.

Mr. Trott supported the staff's recommendation because it simplifies accounting guidance and because fair value is the most relevant measurement attribute for financial instruments.

Mr. Batavick did not support the staff recommendation and is concerned that the scope of the project will substantially expand from the initially intended scope of the project (that is, the removal of the temporary exemption provided by Implementation Issue D1).

Mr. Crooch stated that he supports the staff recommendation because fair value is the most relevant measurement attribute for financial instruments.

Mr. Schieneman stated that he supports the staff recommendation because, in part, it is a simplification of existing guidance.

Ms. Schipper stated that, in preparing for this meeting, she read sections of the dissenting positions to Statements 125 and 140 that were pertinent to, and in favor of, initially measuring retained beneficial interests at fair value. She stated that she was persuaded by arguments presented in the dissent, and the reasons provided by the staff, for accounting for retained beneficial interests at fair value. Ms. Schipper asked the Board to focus on the underlying issue of the project, which she believes is the appropriateness of fair value measurement as it relates to beneficial interests, when determining whether the scope of the project should be expanded.

Mr. Batavick clarified, when he expressed his concern regarding the potential scope expansion of the project, that the due process of the FASB's agenda setting process could be viewed as being circumvented by the creation of such a potentially large-scale project without the Board going through the formal process of adding a major project.

Mr. Herz stated that, while he is sensitive to the issues raised by Ms. Seidman, he is in favor of the staff's recommendation, with the caveat that he is reserving his full support of the recommendation until additional information is provided by the staff as to the potential consequences of allowing retained beneficial interests to be initially measured at fair value. He asked the staff to catalogue the types of instruments and transactions that would lend themselves to initial measurement

at fair value for the Board to consider. He stated that he believes there may be circumstances in which insufficient change may have occurred, thereby not justifying a remeasurement event.

Ms. Schipper suggested that the analysis done in the purchase method procedures project to identify what constitutes a recognition event (specifically, justification for a recognition event as it relates to step acquisitions) might be of interest to the staff in this project.

The Board supported the staff's recommendation and asked the staff to perform additional research to address the concerns provided by the Board. [Five Board members agreed; two objected: Batavick, Seidman.]

Mr. Laurenzano pointed out to the Board that the decision to initially measure retained beneficial interests at fair value was intended to be inclusive of servicing rights. The Board affirmed Mr. Laurenzano's assertion.

#### Follow-up Items:

The staff will perform additional research to address concerns raised by the Board regarding:

- Unforeseen consequences of allowing all beneficial interests (including liabilities) to be initially measured at fair value
- Accounting for transactions where there is no significant change in the underlying economics of the assets.

The objectives of the meeting were met.

#### General Announcements:

None