I do not agree with the proposed treatment of repurchase agreements and securities lending transactions (Repos). I believe it is important for the standard setter to decide on a sound, operational, and conceptually-based approach for determining when a transfer of financial assets result in derecognition and apply that approach consistently. The approach should result in accounting for similar transactions in a similar manner. The prior ownership of financial assets should not influence whether financial assets should be recognized or not. The relationships between the reporting entity and financial assets at the reporting date should determine whether the assets are reported on the balance sheet.

The proposed treatment is a band aid that will lead to more inconsistencies (as acknowledged in the ED’s Basis for Conclusions) and confusion. Similar transactions will not be accounted for in a similar manner (again acknowledged in the ED’s Basis for Conclusions). Also, the acknowledged basis for some of the Boardmembers’ support for the band aid is unsettling. It raises the question of whether a return to a risk/reward approach for determining when financial assets should be derecognized is in the works. I encourage those Boardmembers who look to risk/rewards to study the reasoning in SFAS 125 for the control approach. Risk/rewards had been used prior to SFAS 125. It was not operational. The following are my comments and recommended accounting for Repos. Later, I provide suggestions to improve the use of control as the sound, operational, and conceptually-based approach for determining when to recognize and derecognize financial assets.

**Accounting for Repos**

Reading the SFAS 125 Basis for Conclusions with respect to Repos leads me to believe “effective control” (as used in the Standard) was created to justify the continuation of the existing practice for Repos. It is a “I know the outcome I want, how can I justify that outcome” approach rather than using the control approach to determine the accounting
for Repos. Effective control is a risk/reward approach rather than control for determining the accounting for Repos. Switching the approach to accommodated existing practice for a type of transfer undermines the application of the control approach.

Accounting for Repos should be based on whether the reporting entity controls the transferred financial assets at the reporting date. Continuing to report a non-controlled financial asset based on a forward contract that entitles and obligates the reporting entity to obtain control of transferred assets at a future date does not present a representationally faithful display of the transferred financial assets.

To obtain a faithful representation of the assets and liabilities that exist in a Repo transaction, the transfer and the forward contract should be accounted for separately. The transfer of the financial assets that cause the reporting entity to lose control of those assets should be treated as a sale. The asset and liability that arise from entering into the forward contract should be recognized. The asset is not the financial assets that underlie the forward but a Right to Receive these assets. The liability is the PV of the amount to be paid by the reporting entity at the maturity of the forward. That amount should be used as the initial measurement for the Right to Receive asset.

The following two examples demonstrate what I believe to be the band aid approach and my suggested approach.

**Repo to Maturity**

**Facts:** The reporting entity transfers a $100,000 bond with a remaining term of six months for $105,000 cash. That is the fair value of the bond at the transfer date. The forward contract is for a term of six months and requires the reporting entity to acquire the bond at the forward's maturity date for any contractual cash flows not received by the transferee. All contractual cash flows are paid to the transferee.

**Band aid accounting:** Both the transferred bond and the $105,000 cash are reported on the reporting entity's balance sheet. Also, a liability for $105,000 is reported. At the maturity of the forward contract the bond is derecognized and the liability is settled for a zero payment. The net result is the excess of the bond’s fair value over its carrying amount at the date of the transfer is recognized at the later maturity of the forward.
**My proposed accounting:** The transferred asset is derecognized and a sale reported at the transfer date with a gain of $5,000. The Right to Receive asset and the liability to the transferee are both measured at zero.

**Analysis:** The band aid causes the transferred bond to continue to be reported on the reporting entity’s balance sheet even though the reporting entity has no right to the cash flows of the $100,000 bond and cannot direct how the bond is used. Also, it records a liability for $105,000 to the transferee that is not owed. Essentially, the $105,000 is the maximum amount of the credit guarantee provided by the reporting entity and the $5,000 gain that was not recognized at the transfer date. This is an unfaithful representation of the transaction.

Under my proposed accounting the bond is not reported on the reporting entity's balance sheet and a gain of $5,000 is reported on the transfer date. No liability is recorded. If the bond does not pay all of its contractual cash flows to the transferee, the reporting entity will record an expense and a liability to reflect the credit guarantee that is the result of the forward. I believe this is a faithful representation of the transaction. It is also similar to the accounting that results if the transaction was done by a sale of the bond and the providing of a credit guarantee to the buyer.

**Repo for 90 days**

**Facts:** The reporting entity transfers a debt instrument for $100,000 with a remaining 3-year term for $95,000. That is the fair value of the debt instrument at the transfer date. The forward contract is for 90 days and entitles and obligates the reporting entity to acquire the debt instrument at the forward’s maturity for $90,000. The PV of the $90,000 payment is $88,000. The transferee collects $2,000 from the debt instrument during the 90 days. The fair value of the debt instrument changes only for the $2,000 collected by the transferee during the 90 days.

**Band aid accounting:** Both the transferred debt instrument and the $95,000 cash are reported on the reporting entity's balance sheet. Also, a liability for $95,000 is reported. When the forward matures a gain of $5,000 is reported because the liability is settled for $90,000. Also, a loss of $12,000 is reported to write down the debt instrument to its PV of the remaining contractual cash flows of $88,000. A net loss of $7,000 results.
**My proposed accounting:** The debt instrument is derecognized and a sale reported at the transfer date with a loss of $5,000. The Right to Receive asset and the liability to the transferee are both recorded and measured at the PV of the $90,000 due in 90 days. This amount is $88,000. During the 90 days, the $88,000 liability is accreted to $90,000 and $2,000 in interest expense is recorded. At the maturity of the forward, the acquired debt instrument is recognized at the $88,000 measurement of the Right to Receive and the liability to the transferee is settled for $90,000. A total loss/expense of $7,000 is recorded over the term of the arrangement.

**Analysis:** The band aid causes the transferred $100,000 debt instrument to continue to be reported on the reporting entity's balance sheet even though the reporting entity has no right to the instrument’s cash flows and cannot direct how to use the instrument. Also, it records a liability for an amount greater than owed to the transferee. The loss in value of the debt instrument of $5,000 that exists at the transfer date is not recorded until the maturity of the forward. At the maturity of the forward the entire net loss of $7,000 is reported ($5,000 gain on extinguishment of the debt and $12,000 writedown of the debt instrument).

Under my proposed accounting the debt instrument is not reported on the reporting entity's balance sheet and the $5,000 decrease in the instrument’s value is reported at the transfer date. Interest expense of $2,000 is reported over the term of the forward. The debt instrument is recognized when the reporting entity settles the forward. I believe this is a faithful representation of the transaction. Under my accounting, if the fair value of the debt instrument changes during the term of the forward, the measurement of the Right to Receive asset is adjusted with a gain/loss recognized. The debt instrument is recorded at the carrying value of the Right to Receive asset when it is acquired.

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My proposed accounting requires more entries to be made. However, the information for those entries should be readily available and already captured in the accounting system. The major change that reporting entities will need to make is the use of trade-date accounting rather than settlement-date accounting for acquiring and selling financial assets and the recording of the asset and liability of forward contracts for financial assets.
The benefit of my proposed approach is that the balance sheet will report a faithful representation of the assets controlled and the liabilities owed. Gain/losses will be reported timely. Finally, the accounting will not allow a reporting entity to misrepresent its leverage.

**Suggestions to Improve the Use of Control**

I believe the use of control for determining the recognition/derecognition of financial assets would be strengthened and made more operational and intuitive if the term was defined in the transfer literature. I suggest the following as a draft definition.

"Control of a financial asset exists when the reporting entity has the ability to exchange or decide how to use the financial asset."

Using a definition rather than “conditions” to identify a “surrender of control” can be applied more broadly as new forms of transfers are created. If “conditions” continue to be desired to assist the understanding of the definition, they can be developed to supplement the definition.

Using a definition may eliminate the “condition” of isolation and reduce the reliance on the legal profession for making an accounting judgment. In my experience, incorporating a legal determination of isolation has not made the accounting judgment of whether control exists either more simple or consistent.

I also recommend the relationship of control and risks/rewards be discussed. The following is my view of this relationship.
• Control provides the present right to some of the risks/rewards of the controlled financial asset.

• Determining who has risks/rewards of a financial asset will identify possible controlling entities. However, a comparison of the relative amount of risks/rewards among the possible controlling entities is not conclusive. The ability to make decisions with respect to a financial asset creates control.

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Please contact me at ewtrott@gmail if you would like to discuss these comments.

Sincerely,

Edward W. Trott