COMPLIANCE WEEK
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Companies Welcome Off-Balance Sheet Reforms

By Tammy Whitehouse — September 23, 2008

Just as the federal government engineers historic bailouts for financial giants like Fannie Mae, Freddie Mac, and insurer AIG, an accounting rule proposal aims to end the kind of off-balance-sheet accounting that contributed to such spectacular demise.

Given the fragility of capital markets and the political pressures at play, though, it's possible the rule will never hit U.S. capital markets, accounting experts warn.

In a three-part plan to revise existing accounting rules, the Financial Accounting Standards Board proposes amending Financial Accounting Standard No. 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* to end the use of qualifying special-purpose entities that allow off-balance sheet trading in complex securitizations. The plan also would amend Financial Interpretation No. 46R *Consolidation of Variable Interest Entities* to require enterprises with involvement in such entities to continually reassess who owns and controls them, and therefore should consolidate them to their corporate balance sheet.

Currently, the QSPE is a staple in FAS 140*,* where some bright-line criteria around packaged and transferred securities enable "transferors," or sellers of the complex securities, to get sale accounting. That means the related assets and liabilities are accounted for as if they were sold—moved off the books for accounting purposes—while in practice the selling financial institutions typically had a strong hand in managing such assets.

The QSPE has been used heavily in turning debt, such as residential mortgages and credit card balances, into marketable securities. It was the collapse of sub-prime mortgages and the cascade into other credit market problems that exposed how aggressively such securities were traded in off-balance sheet structures and how risky they proved to be.

The Securities and Exchange Commission stepped in to settle disturbing questions about how financial institutions that originated troubled loans could work them out with debtors—even as they were treated as transferred and sold assets—signaling to the markets that the instruments weren't so isolated from banks' control after all. The SEC and Congress tasked the FASB to rework the rules.

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Under FASB's proposal, the assessment of who should consolidate such in-limbo securities would focus not on who enjoys the benefits and assumes the risk related to the assets, says David Kane, a partner with Ernst & Young. Instead, the criteria focused on who has power or control over the instruments.

"Do you have the ability to make significant decisions that could affect the economic success of the entity?" queries Kane. "That would include significant operating decisions, capital decisions, things that could affect the ultimate cash flow or value of the entity."

The result of applying such a test, says Robert Uhl, a partner with Deloitte, is many of the instruments held off balance sheet today will not be offloaded to the "buyer" of the securities but will be brought back onto the balance sheets of the financial institutions that originated the instruments. "It will blow up the balance sheet," he says.

If a bank is putting receivables in a securitization trust and also serves as manager of that trust with the power to manage day-to-day activities of the trust, "it's likely under this proposal that they would have to consolidate that trust, which means you could never get sale accounting," Uhl says. "All those receivables will stay on the balance sheet. All the proceeds the trust went out and got by selling beneficial interests—that will come on the balance sheet as liabilities. The net effect is we're going to balloon these transferors' balance sheets."

That, in turn, will tax banks' ability to meet their capital requirements, says Rebecca Albarelli, global practice leader of finance operations for Jefferson Wells. Banks are required to maintain set levels of liquidity based on their balance sheets, she says.

While the numbers would never protect a given bank in a real run by consumers, the ratios are already conservative in the United States compared with what's required of international banks, according to Albarelli. "We don't need to make things more difficult for banks right now," she says. "I believe that's why there's been a delay in getting this through FASB."

The American Securitization Forum said it agrees the accounting needs to be revised, but it's worried about the result. "We are concerned that the proposed changes may impair securitization market activity, by making it more difficult and expensive to finance mortgage, automobile, credit card, student loan, and other forms of consumer and business debt," said George Miller, executive director of the ASF in a statement. "This could materially reduce the availability and increase the cost of credit in the United States."

FASB's proposed effective date would push the new accounting into 2010, allowing a long lead time for what is sure to be a contentious debate. The board reluctantly agreed this summer to defer its originally planned effective date to allow more time to prepare for the change. Board members said then, however, it would not soften their resolve to make the change.

Other Proposals

In lieu of a quick effective date for new accounting, FASB also is proposing Staff Position FAS 140-e and FIN 46 (R)-e, *Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities*, to compel new disclosures about off-balance sheet activities that it hopes to have in place for 2008 year-end reporting.

The proposed disclosure requirements are extensive, says Deloitte's Uhl, resulting in a great deal more work if adopted. "I could see that being potentially controversial," he says.

Uhl also points out that the revisions proposed by FASB would affect not only entities established to facilitate securitization, but also entities like joint ventures that are common for manufacturing and other kinds of enterprises. "I'm worried about unintended consequences on non-financial companies," he says.

FASB points out in its proposal that its intended direction would move U.S. Generally Accepted Accounting Principles closer to International Financial Reporting Standards. At the same time, the International Accounting Standards Board also has a project in play to review and potentially revise accounting around consolidation.

Given the U.S. gravitation toward international rules, Uhl believes commenters will argue FASB's proposed change will result in too many changes too quickly—a change in GAAP in 2010, followed by a switchover to IFRS, which could then involve a further change if IASB revises those rules later as well.

"That's going to be a very common theme in comment letters to FASB," he says. "This may never see the light of day. By the time it would become effective, a convergence project might have already superseded them."

FASB is accepting comments on the proposal through Nov. 14. The board also is planning a Nov. 6 roundtable to air views on the proposals, with advance registration required to participate.

SECURIZATION QUESTIONS

The Financial Accounting Standards Board invites individuals and organizations to comment on the following questions in regard to its proposed revisions to FAS 140. Comments are due by Nov. 14, 2008:

1. Will the proposed Statement meet the project's objective to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about (a) a transfer of financial assets, (b) the effects of a transfer on its financial position, financial performance, and cash flows, and (c) a transferor's continuing involvement in transferred financial assets?

2. Do you agree with the Board's decisions to eliminate the qualifying SPE concept and to require that all securitization entities be evaluated for consolidation under applicable U.S. generally accepted accounting principles? If not, why not?

3. Certain financial statement users suggested that the Board adopt a no- continuing-involvement model (that is, if there is any continuing involvement, sale accounting would not be permitted). The Board decided to continue to permit derecognition of financial assets with continuing involvement as long as the conditions in paragraph 9 of Statement 140, as amended by this proposed Statement, are met, with the addition of enhanced disclosure requirements about a transferor's continuing involvement (see paragraph A28 of this proposed Statement). Do you agree with this decision? If not, why do you disagree and what approach would you recommend to meet the needs of financial statement users for additional information on transferred financial assets?

4. What costs do you expect to incur if the Board were to issue this proposed Statement in its current form as a final Statement? How could the Board further reduce the costs of applying these requirements without significantly reducing the benefits?

5. The Board decided to establish specific conditions for reporting a transfer of a portion of a financial asset as a sale. A transfer of a portion of a financial asset as a sale is eligible for derecognition only for a pro rata portion that meets the definition of a participating interest. Do you agree with this decision? If not, why do you disagree? If you agree with the Board's decision to limit the portions of a financial asset that are eligible for derecognition, do you agree with the definition of a participating interest? If not, what alternative definition do you recommend and why?

6. Paragraph 9(c) of Statement 140 and the related implementation guidance, as amended by this proposed Statement, require that the transferor (a) not maintain effective control over transferred financial assets to account for a transfer as a sale and (b) provide examples of effective control. The Board decided to incorporate many of the concepts from paragraph 9(b) of Statement 140 into paragraph 9(c), which results in the creation of the additional examples that are included in paragraphs 9(c)(3) and 9(c)(4). Do you believe that paragraph 9(c) of Statement 140 and the related implementation guidance, as amended by this proposed Statement, clearly explain how to determine if the transferor maintains effective control? If not, what additional guidance or examples are necessary?

Do you believe that paragraph 9(c), as amended by this proposed Statement, is operational in its entirety in its current form? If not, what changes are necessary? Do you believe these additional examples of effective control in paragraphs 9(c)(3) and 9(c)(4) are operational in their current form? If not, what changes are necessary?

7. Certain financial statement users strongly recommended that the Board provide disclosure principles and require certain specific disclosures for both transferred financial assets treated as sales and those that are treated as secured borrowings. Do you agree that additional disclosures about transferred financial assets are necessary and operational? If not, what changes would you make to the requirements? Do you believe that the revisions to the disclosure requirements are sufficient? If not, what additional disclosures do you believe are necessary?

8. Appendix C includes significant amendments, primarily as a result of this proposed Statement, to related literature including (a) the FASB Special Report, *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, (b) certain Emerging Issues Task Force (EITF) Issues and Topics, and (c) certain AICPA Audit and Accounting Guides. Do you agree that the related literature, as amended, is consistent with the proposed amendments to Statement 140? If not, why do you disagree and what changes would you make?

9. Due to differences in financial statement user needs and cost-benefit considerations, should any differences exist for recognition, measurement, disclosure, transition, or effective date for private companies? If yes, please articulate what differences should exist and the reasons for those differences.

Source

FASB Revision to Amendment of FASB Statement No. 140 (Sept. 15, 2008).

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