

# INTERNATIONAL HARMONIZATION OF ACCOUNTING STANDARDS, AND THE QUESTION OF OFF-BALANCE SHEET TREATMENT

PETER JEFFREY\*

## I. INTRODUCTION

Determining whether a transaction, particularly a securitization, results in assets leaving a balance sheet has recently proven to be one of the most challenging areas for accounting standard setters. There are presently three approaches to this question. The Generally Accepted Accounting Principles of the United States (U.S. GAAP) was the first to address the issue of off-balance sheet accounting and, in the absence of standards in other jurisdictions, became influential in Asia as well as in both South and North America.<sup>1</sup> The Generally Accepted Accounting Practice in the United Kingdom (U.K. GAAP) also applies to Ireland and has influenced Commonwealth countries such as South Africa and Australia at various times.<sup>2</sup> Finally, with its new robust and more comprehensive set of standards, the approach

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\* Head of Pricewaterhouse Coopers European Securitisation Group; Co-chair European Securitisation Forum Accounting Committee. The author would like to thank Gregg Kohansky for assistance in writing this article.

1. In the United States, the Financial Accounting Standards Board (FASB) first addressed off-balance sheet accounting in November 1983 with statements No. 76, Extinguishment of Debt; and No. 77, Reporting by Transferors for Transfers of Receivables with Recourse. *See* FIN. ACCT. STANDARDS BOARD, STATEMENT OF FIN. ACCT. STANDARDS NO. 76: EXTINGUISHMENT OF DEBT—AN AMENDMENT OF APB OPINION NO. 26 (1983); FIN. ACCT. STANDARDS BOARD, STATEMENT OF FIN. ACCT. STANDARDS NO. 77: REPORTING BY TRANSFERORS FOR TRANSFERS OF RECEIVABLES WITH RECOURSE (1983). These statements have subsequently been replaced by statements No. 125 and No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities. After privatizations and subsequent initial public offerings in the United States of South American and Mexican corporations in the 1980s and 1990s, adoption of U.S. GAAP became imperative.

2. The creation of certain off-balance sheet financing vehicles in the 1980s resulted in transactions which, though abiding by previous standards in legal form, did not report the commercial effect of the arrangement. However, despite a number of proposed standards, a definitive accounting standard, Financial Reporting Standard 5 (FSR 5), was not adopted until April 1994 by FASB.

of the International Accounting Standards (IAS) has been or will be adopted in many more countries, especially across Europe.

European countries have had a variety of accounting standards, many of which had a tax or regulatory base. These were often rule-based rather than principle-based and lacked the flexibility needed to handle market developments such as securitizations. The European Commission announced that member states should adopt IAS from 2005 for listed companies and in practice many will adopt IAS for all companies.<sup>3</sup> Securities regulators and markets favor the harmonization of accounting standards and intend to utilize IAS to do so, with the ultimate aim of achieving a unified set of standards.

Part II of this article explores and explains the three approaches to accounting for securitization transactions. Part III then discusses how harmonization of these approaches might occur and the difficulties of achieving harmonization. Finally, Part IV explores how accounting standards and their approaches to on- or off-balance sheet treatment might affect the securitization market and its growth.

## II. OVERVIEW OF ACCOUNTING STANDARDS

### A. U.S. GAAP

The U.S. securitization market is enormous, with around \$300 billion of public issues expected for 2001.<sup>4</sup> A fundamental operating methodology for many companies in a variety of industries, securitization has influenced the United States in its adoption of standards that have allowed securitized assets to be easily taken off balance sheets or derecognized. The current Financial Accounting Standards Board (FASB) statement, *Accounting for Transfers and Servicing of Financial Assets and Extinguishing of Liabilities* (FAS 140), continues this approach through reinforcing rules that must be met to allow off-balance sheet treatment.<sup>5</sup> Under FAS 140, the accounting of a securi-

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3. Commission Proposal for a Regulation of the European Parliament and of the Council on the Application of International Accounting Standards, 2001/004 (COD), available at [http://europa.eu.int/comm/internal\\_market/en/company/account/news/6941en.pdf](http://europa.eu.int/comm/internal_market/en/company/account/news/6941en.pdf) (last visited Feb. 11, 2002).

4. *US ABS Issuance*, ASSET-BACKED ALERT, (Feb. 22, 2002) (reporting an increase in U.S. issuance of seventeen percent from \$282 billion in 2000 to \$330 billion in 2001), at <http://www.abalert.com/Public/MarketPlace/MarketStatistics/index.cfm> (last visited Mar. 26, 2002).

5. FIN. ACCT. STANDARDS BOARD, STATEMENT OF FIN. ACCT. STANDARDS NO. 140: ACCT. FOR TRANSFERS AND SERVICING OF FIN. ASSETS AND EXTINGUISHMENTS OF LIABILITIES (2000) [hereinafter FAS 140].

zation transaction depends on the terms of the particular structure adopted and can be performed in one of the following four ways:

- As a sale, when the seller or originator has no continuing involvement with the transferred assets;
- As a financing, when the FAS 140 requirements for sale accounting are not met;
- As neither a sale nor financing, when no proceeds are involved other than interests in the transferred assets such as mortgage-backed securities;
- As a partial sale, when the transferor retains servicing and/or an interest in the assets and the FAS 140 sale criteria are met.<sup>6</sup>

This last approach is used in most securitizations and results in the cash funding and assets being omitted from the balance sheet, while the retained interests remain on the balance sheet, albeit in a new form such as mortgage servicing rights.

To qualify for sale treatment under FAS 140, the assets must be beyond the reach of the transferor's creditors.<sup>7</sup> To achieve this, one must demonstrate that there has been a true sale of the assets to another party, usually a special purpose entity (SPE).<sup>8</sup> True sale is usually evidenced by a legal opinion. If a true sale occurs, the SPE can use the assets freely as an owner; for example, it has the ability to pledge the assets. Next, one must demonstrate that upon the bankruptcy of the seller, its creditors cannot make a claim on the assets of the SPE; that is, the SPE is bankruptcy remote from the transferor.

Unlike its predecessor standard,<sup>9</sup> FAS 140 clearly states that the assets and liabilities of a Qualifying SPE (QSPE) do not need to be consolidated into the financial statements of the transferor.<sup>10</sup> FAS 140 also places restrictions on the entity's activities and the assets and derivatives it may hold, and all of the commercial decisions of the QSPE are predetermined.<sup>11</sup> It is unclear what accounting principles are used to justify not consolidating these types of SPEs. For this reason, other accounting standard setters have not easily accepted such a

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6. *Id.* ¶¶ 2, 4–7.

7. *Id.* ¶ 9(a).

8. *Id.*

9. FAS 140 is a replacement of FIN. ACCT. STANDARDS BOARD, STATEMENT OF ACCT. STANDARDS NO. 125: ACCT. FOR TRANSFERS AND SERVICING OF FIN. ASSETS AND EXTINGUISHMENTS OF LIABILITIES (1996).

10. FAS 140, *supra* note 5, ¶ 46.

11. *Id.* ¶ 35(b) (“[A QSPE’s] permitted activities (1) are significantly limited, (2) were entirely specified in legal documents that established the SPE, . . . and (3) may be significantly changed only with the approval of the holders of at least a majority of beneficial interests held by entities other than any transferor, its affiliates, and its agents.”).

concept. It seems more a method to allow off-balance sheet securitizations than good accounting practice. Finally, FAS 140 reinforces the previous rules on the transfer of assets from the SPE to the transferor and on the option arrangements allowed between the SPE and transferor.<sup>12</sup>

Under U.S. GAAP therefore, sale treatment, and thus derecognition of the assets, is readily obtainable if certain rules are followed. Accordingly, since a sale has been achieved, a gain or loss on sale is also recognized.

## B. U.K. GAAP

While the United Kingdom accounting standard setters came under the same pressure as the United States to allow off-balance sheet treatment for securitizations, the British responded differently. Rather than allow full derecognition of assets, they developed a disclosure regime that reflects the financing nature of a transaction by allowing the funding to be netted off the assets, subject to extensive disclosure requirements. This netting approach, known as linked presentation, has little support from accounting theory but was a compromise to help the securitization market by allowing originators to achieve a certain amount of off-balance sheet treatment.<sup>13</sup>

The U.K. accounting treatment is governed by *Financial Reporting Standard 5, Reporting the Substance of Transactions*, issued by the Accounting Standards Board in 1994 (FSR 5).<sup>14</sup> Application Note D of this standard deals specifically with securitization transactions,<sup>15</sup> although Application Note E on loan transfers is also often relevant.<sup>16</sup> Some of the key points of this treatment are discussed below.

Under the U.K. approach, opting for substance over form, one cannot categorize a particular transaction as on- or off-balance sheet merely by reference to its legal structure. The accounting impact of each transaction must instead be judged carefully after analyzing the transaction, the reason it is being entered into, and of particular im-

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12. *Id.* ¶ 9.

13. Margo Jensen, *Accounting Treatment for Securitizations: Uncertainty and Alternatives*, GTNEWS, Dec. 21, 2001, at [http://www.gtnews.com/articles\\_se/4087.html](http://www.gtnews.com/articles_se/4087.html) (last visited Mar. 24, 2002).

14. ACCT. STANDARDS BOARD, FIN. REPORTING STANDARD 5: REPORTING THE SUBSTANCE OF TRANSACTIONS (1994) [hereinafter FRS 5].

15. Application Note D—Securitized Assets, *in* FRS 5, *supra* note 14, at 88.

16. Application Note E—Loan Transfers, *in* FRS 5, *supra* note 14, at 105.

portance, its effect in practice.<sup>17</sup> Assets already recognized in a company's accounts should continue to be recognized when involved in a transaction that does not significantly change the entity's benefits or risks stemming from those assets.<sup>18</sup> Therefore, an asset is derecognized only where the entity transfers all significant benefits and risks. Benefits and risks are broadly defined and not just limited to credit risk.<sup>19</sup> A profit or loss may arise on derecognition and should be recognized on a prudent basis.

In practice, almost all U.K. securitizations adopt linked presentation accounting. In the balance sheet, linked presentation shows the related finance deducted from the asset or portfolio of assets it finances and applies in situations where the asset cannot be derecognized as there has not been a significant change in the benefits or risks stemming from the asset. Linked presentation can only be used where the following conditions are met:

- The finance must relate to a specific asset or portfolio of assets and be secured on no other assets;
- The finance provider cannot have any recourse whatsoever to the entity's other assets and must state so in writing. The finance may only be repaid from funds from the securitized assets;
- The directors must note in the accounts that the entity is not obliged to support any losses and does not intend to do so;
- If the funds the asset generates are insufficient to repay the finance, this must not constitute a default for other finance provided to the entity; and
- The entity cannot keep or re-acquire the asset upon repayment.<sup>20</sup>

The linked presentation is designed to be used for securitization schemes. While not removing the securitized assets from the balance sheet, the linked presentation method effectively achieves a similar

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17. Though the FRS 5 will not change the treatment for most transactions, according to paragraph C of the Summary, those requiring more analysis include features such as situations where "the party that gains the principal benefits generated by an item is not the legal owner of the item; a transaction is linked with others in such a way that the commercial effect can be understood only by considering the series as a whole; and an option is included on terms that make its exercise highly likely." FRS 5, *supra* note 14, ¶ C.

18. According to paragraph I of the FRS 5 summary, "Where the transaction transfers to others all significant rights to benefits and all significant exposure to risks, the entity should cease to recognise the asset in its entirety." *Id.* ¶ I.

19. Paragraph E6 of Application Note E sets out the benefits and risks that should be considered for interest bearing assets. Application Note E—Loan Transfers, *in* FRS 5, *supra* note 14, at 105, 108.

20. FRS 5, *supra* note 14, ¶ 27.

result. However, since no sale is recognized, no gain or loss on sale can be recognized. A company can choose to show a transaction gross by breaking the linked presentation condition regarding the disclosures to be made in the accounts. Insuring against risks does not relieve an entity of its obligations in relation to those risks and has no bearing on whether the insured asset can be re-recognized. If the conditions for linked presentation hold for only part of the finance, then the linked presentation can still be used for that part of the finance.<sup>21</sup>

In summary, U.K. GAAP offers three potential treatments: derecognition, linked presentation, and separate presentation. Table 1 displays these approaches and their characteristics. It should be noted, however, that even if re-recognition is appropriate for the originator, it is possible that a special purpose vehicle (SPV) may be recaptured on the balance sheet via rules on quasi-subidiaries where a sponsor or repackager has a significant interest in the rewards of the asset pool.<sup>22</sup>

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21. *Id.*

22. *Id.* ¶ 96.

**TABLE 1**  
**SUMMARY OF TREATMENT OF SECURITIZATION TRANSACTIONS**  
**UNDER U.K. GAAP**

	<b>Derecognition</b>	<b>Linked presentation</b>	<b>Separate presentation</b>
<b>Price/proceeds</b>	Transaction price is arm's length price for an outright sale. Transfer is for a single non-returnable sum.	Some non-returnable proceeds are received, but originator has rights to further sums from the issuer, the amount of which depends on the performance of the securitized assets.	Proceeds received are returnable, or there is a provision whereby the originator may keep the securitized assets on repayment of the loan notes or re-acquire them.
<b>Recourse</b>	There is no recourse to the originator for losses.	There is either no recourse for losses, or such recourse has a fixed monetary ceiling.	There is, or may be, full recourse to the originator for losses.
<b>Issuer</b>	Issuer is owned by an independent third party that has made a substantial capital investment, has control of the issuer and has the benefits and risks of its net assets.	Issuer is a quasi-subsubsidiary of the originator, but the conditions for a linked presentation are met from the point of view of the group.	Often, issuer is a subsidiary of the originator, although linked presentation may still be possible.

### C. International Accounting Standards

Standard Number 39, *Financial Instruments: Recognition and Measurement*, is the primary IAS regarding accounting treatment for securitization.<sup>23</sup> U.S. GAAP heavily influences this standard, and in connection with derecognition, the concept of true sale applies.<sup>24</sup> As with U.S. GAAP, it would not be hard, therefore, to achieve an off-

23. INT'L ACCT. STANDARD 39: FIN. INSTRUMENTS: RECOGNITION AND MEASUREMENT (2000), reprinted in INT'L ACCT. STANDARDS COMM., INT'L ACCT. STANDARDS 2001, at 1153.

24. *Id.* ¶¶ 35, 41, reprinted in INT'L ACCT. STANDARDS COMM., INT'L ACCT. STANDARDS 2001, at 1153, 1185, 1186.

balance sheet securitization were this the only applicable IAS pronouncement. However, in determining the appropriate accounting treatment for a securitization under IAS, one should consider the Standing Interpretations Committee (SIC) Pronouncement Number 12 (SIC 12).<sup>25</sup> This pronouncement dictates when a SPE must be consolidated into the financial statements of another enterprise.

Unfortunately, SIC 12 is poorly drafted and difficult to interpret. According to SIC 12, an SPE should be consolidated if an enterprise has control of the SPE.<sup>26</sup> In particular, if a transferor retains the residual income of the SPE, it should consolidate the SPE. Because most securitizations require some method for extracting residual income from the SPE back to the transferor, the SPE needs to be consolidated, and the off-balance sheet treatment achieved under IAS 39 is reversed by SIC 12.

Most commentators agree that an off-balance sheet securitization is not possible under IAS because of SIC 12.<sup>27</sup> Again, since no sale is recognized at a consolidated level, no gain or loss is recognized.

#### D. Summary of Accounting Standards

Table 2 summarizes how a typical securitization structure would be treated under U.S. GAAP, U.K. GAAP, and IAS.

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25. STANDING INTERPRETATIONS COMMITTEE PRONOUNCEMENT NO. 12: CONSOLIDATION—SPECIAL PURPOSE ENTITIES (1998), *reprinted in* INT'L ACCT. STANDARDS COMM., INT'L ACCT. STANDARDS 2001, at 1385.

26. *Id.* ¶ 8, *reprinted in* INT'L ACCT. STANDARDS COMM., INT'L ACCT. STANDARDS 2001, at 1385, 1386.

27. Letter from Scott Christopher Rankin, Managing Director, European Securitisation Forum, and Peter Jeffrey, Co-Chairman, ESF International Accounting Task Force, to Sir David Tweedle, Chairman, International Accounting Standards Board (Oct. 30, 2001), *available at* [http://www.europansecuritisation.com/assets/introductory\\_letter\\_to\\_iasb.pdf](http://www.europansecuritisation.com/assets/introductory_letter_to_iasb.pdf) (last visited Mar. 24, 2002).



**TABLE 2**  
**SUMMARY OF TREATMENT OF SECURITIZATION TRANSACTIONS**

	US GAAP	UK GAAP	IAS
<b>Balance sheet treatment</b>	<ul style="list-style-type: none"> <li>● Assets sold removed from balance sheet.</li> <li>● Recognize deferred consideration, subordinated loan, and mortgage servicing rights at fair value.</li> <li>● Asset-backed bond not recognized on balance sheet.</li> </ul>	<ul style="list-style-type: none"> <li>● Assets remain on balance sheet.</li> <li>● Asset-backed bond netted on asset side of balance sheet to give a net asset of 15.</li> </ul>	<ul style="list-style-type: none"> <li>● Assets remain on balance sheet.</li> <li>● Asset-backed bonds show as liability.</li> </ul>
<b>Income statement</b>	<ul style="list-style-type: none"> <li>● Gain on sale recognized.</li> <li>● Adjustments to fair values recognized year on year as well as discount unwind.</li> </ul>	<ul style="list-style-type: none"> <li>● No gain on sale.</li> <li>● Interest receivable and payable netted and shown net in interest receivable.</li> </ul>	<ul style="list-style-type: none"> <li>● No gain on sale.</li> <li>● Interest receivable and payable shown gross.</li> </ul>
<b>SPE</b>	<ul style="list-style-type: none"> <li>● Not consolidated as long as a QSPE.</li> </ul>	<ul style="list-style-type: none"> <li>● Usually a quasi-subsidiary with disclosures.</li> </ul>	<ul style="list-style-type: none"> <li>● Fully consolidated.</li> </ul>

Although the three major accounting standards cover all accounting possibilities, they are diametrically opposed to each other. That the same transaction can be accounted for in such different ways under the major accounting standards is not logical. Such a situation confuses investors and the capital markets and casts doubt on the validity of the accounting standards themselves.

### III. HARMONIZATION OF ACCOUNTING STANDARDS

An active movement is developing to harmonize accounting standards, and in the short term, with many countries' conversion to IAS, the world is likely to have two main accounting regimes, IAS and U.S. GAAP. However, a harmonization of IAS and U.S. GAAP will be much more problematic. Modification of IAS to address issues in the same depth and detail as U.S. GAAP will take time. Additionally, because of the novelty of the robust IAS framework, there is concern, particularly in the United States, that international stan-

dards will not be implemented or interpreted consistently thus defeating the aim of consistent accounting standards. Other barriers to harmonization include specific contrasting approaches to certain transactions, such as those applying to securitizations discussed above.

One approach to harmonize securitization transactions is to repeal SIC 12 and amend IAS 39 to recognize that SPEs used in securitizations need not be consolidated, effectively aligning IAS with U.S. GAAP. Such an approach is unlikely, especially after the fallout of Enron in the United States. As a short-term measure, the SIC should rewrite SIC 12 to clarify when consolidation of an SPE is necessary and what level of risk and reward triggers such consolidation.

An argument may be made for changing IAS, as its current approach fails to recognize that a significant transaction occurs when the risks and rewards profile of companies and securities is changed by such a transaction. Intuitively, one might suspect some impact on the balance sheet of the securitizer after a securitization. A securitization is much more than a funding transaction since risk is transferred to the funders. By retaining the assets securitized on the balance sheet in their original form, the full benefit of ownership that is no longer available to the transferor goes unrecognized.

IAS could be changed to account for a securitization by recognizing that the asset-backed bonds will only be repaid from the proceeds of the assets. In effect, the only asset remaining for the account of the company is the net asset (i.e., securitized assets minus funding), which should be recognized on the balance sheet. This approach recognizes the level of assets that the company has at risk and removes the funding from the balance sheet and associated assets without recognizing a sale. Effectively, the securitized asset is substituted for a different type of asset that reflects the occurrence of a securitization with different risks and rewards. Any gain or loss is deferred in the balance sheet and recognized over the original life of the securitized assets thus not bringing forward profits as does U.S. GAAP.

Probably the greatest concern regarding U.S. GAAP is its triggering of gain-on-sale accounting. Arguably, it is imprudent to recognize lifetime profits on securitized assets solely because a securitization has taken place. This problem is best left to the current debate on fair value accounting of all financial assets.

#### IV. THE EFFECT OF ACCOUNTING STANDARDS ON THE SECURITIZATION MARKET

The frequent argument put forth by accounting standard setters that accounting standards do not and should not affect the rationale for undertaking transactions is naïve. Clearly, companies that enter into a securitization solely as an effective method of funding may not be concerned as to whether the securitized assets are on- or off-balance sheet. The question of whether the securitized assets are on- or off-balance sheet is less clear in the case of securitizations designed to reduce regulatory capital requirements. Regulators are obviously free to determine their own regulations and not follow the accounting treatment and in some respects, the recent Basel proposals illustrate this freedom.<sup>28</sup> However, regulators have historically been reluctant to move away from audited financial statements. The use of significantly different balance sheets in financial statements from those used for regulatory capital measurement is an unsatisfactory situation.

Securitizations are beneficial for many companies in that they raise cost effective funding, provide equity, transfer risk (similar to catastrophe insurance), encourage risk management, and promote overall operational efficiency. If none of the benefits are recognized in the financial statements, scientism of the technique and depression of the securitization market are bound to result.

#### V. CONCLUSION

Currently, accounting standards treat securitizations in different ways. The same transaction can be on- or off-balance sheet depending on the accounting regime employed. This inconsistency undermines the purpose of the standards and injures the capital markets.

To enable harmonization of accounting standards, both IAS and U.S. GAAP must change. IAS fails to recognize the benefits and changes in risk and rewards brought about by a securitization, while U.S. GAAP is imprudent in bringing forward profit recognition through securitization. A common standard that addresses these issues is needed. Without a harmonized accounting standard for securitizations, the securitization market will not develop as rapidly as it could, to the detriment of businesses, capital markets, investors, and regulators.

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28. See BASEL COMM. ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: THE NEW BASEL CAPITAL ACCORD (2001), available at <http://www.bis.org/publ/bcbsca03.pdf> (last visited Feb. 21, 2002).