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INTERNATIONAL HARMONIZATION OF ACCOUNTING STANDARDS: A HOLY GRAIL THAT EXCEEDS EVEN THE GRASP OF INDIANA JONES

A COMMENT ON JEFFREY

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Mr. Jeffrey's article, *International Harmonization of Accounting Standards and the Question of Off-Balance Sheet Treatment*, provides an insightful discussion of different accounting approaches to the question of when a transaction, particularly a securitization, results in off-balance sheet treatment of assets and liabilities.[1] Mr. Jeffrey notes that this issue has proved extremely challenging to accounting standards setters, and argues that while securities regulators and markets are keen to harmonize accounting standards, the different approaches—represented by the U.S. accounting standards (U.S. GAAP), U.K. accounting standards (U.K. GAAP), and International Accounting Standards (IAS)—are not easily harmonized.

Under U.S. GAAP, Financial Accounting Standards Board (FASB) statement 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishing of Liabilities*[2] (FAS 140), provides that a securitization may be accounted for in one of four ways—most commonly, as a partial sale, where the transferor retains servicing and/or interests in the assets and the FAS 140 sale criteria are met. Mr. Jeffrey notes that this approach results in the cash funding and related assets and liabilities being taken off the balance sheet, while the retained interests remain on the balance sheet (albeit in an new

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1. Peter Jeffrey, *International Harmonization of Accounting Standards, and the Question of Off-Balance Sheet Treatment*, 12 DUKE J. COMP. & INT'L L. 341 (2002).

2. 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].

form such as mortgage servicing rights).[3] To qualify for sale treatment under FAS 140, one must demonstrate, first, that there has been a true sale of assets to a special purpose entity (SPE) and, second, that on the bankruptcy of the seller, its creditors cannot make a claim on the assets of the SPE (i.e., the SPE is bankruptcy remote from the transferor).[4] Further, FAS 140 clearly states that a Qualifying SPE's (QSPE) assets and liabilities do not need to be consolidated in the financial statements of the transferor. To be a QSPE, the entity must, in most circumstances, be on "automatic pilot;" in other words, most of the commercial decisions of the entity are predetermined.[5]

Mr. Jeffrey notes that it is unclear what accounting principles are used to justify not consolidating these types of SPEs, and that other accounting standard setters find the defining of QSPEs a difficult concept to accept. He argues that the practice seems more driven by the need to allow off-balance sheet securitizations than good accounting practice.[6] I disagree. It would be misleading to consolidate the QSPEs if the transferor is in fact not exposed to its liabilities and does not have access to its assets in the traditional manner an owner can use its assets. Showing the transferor's investment in the QSPE's assets is a much fairer and less misleading representation of what is going on.

In his analysis of the trend towards harmonization of accounting standards, Mr. Jeffrey also notes that, at least in the short term, it is likely that IAS and U.S. GAAP will operate as the two main accounting regimes globally.[7] However, he argues that the harmonization of IAS and U.S. GAAP is problematic for a number of reasons.[8] One approach towards harmonization would be the repeal of the Standards Interpretation Committee Pronouncement Number 12 (SIC 12), which provides that an SPE should be consolidated if an en-

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3. Jeffrey, *supra* note 1, at 343.

4. FAS 140, *supra* note 2, ¶ 35.

5. *Id.* Note that while there are precise restrictions on sales of assets, there are no explicit restrictions on issuance, or reissuance, of liabilities to finance those assets. Further, while FAS 125's definition of a QSPE was written such that it could have no powers other than four prescribed powers, *see* FIN. ACCT. STANDARDS BOARD, STATEMENT OF FIN. ACCT. STANDARDS NO. 125: ACCT. FOR TRANSFERS AND SERVICING OF FIN. ASSETS AND EXTINGUISHMENTS OF LIABILITIES ¶ 26 (1996), paragraph 35 of FAS 140 is written solely to prohibit certain actions; it is silent on what is permitted. Presumably, a strong argument in interpreting paragraph 35 is the traditional common law principle of interpretation that what is not prohibited is permitted.

6. Jeffrey, *supra* note 1, at 344.

7. *Id.* at 349.

8. *Id.* at 349–50.

terprise has in substance control of the SPE,[9] and the amendment of IAS to recognize that SPEs used in securitizations do not need to be consolidated, thus "effectively aligning IAS with US GAAP."[10] This, however, he regards as unlikely in view of the fallout from Enron, and recommends, as a short term measure, rewriting SIC 12 to provide for circumstances where the distribution of risks and rewards may or may not require consolidation.[11] I do not agree that Enron will lead FASB to adopt a draconian alternative to the present rule. Rather, I expect them to adopt a rule which more or less recognizes the economic substance of most securitizations, for example, continuing to require consolidation of QSPEs by corporate parents. The substance of the use of SPEs in most securitizations is to reallocate risks and rewards. Consolidation is usually more misleading (than lack of consolidation) because it is opaque to this reallocation. Indeed, in the next paragraph of Mr. Jeffrey's article, discussed below, we seem to agree substantially on this point.

In that next paragraph, Mr. Jeffrey goes on to note that "[a]n 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."[12] It seems intuitive that after a securitization there must be some impact on the securitizer's balance sheet—in fact, a securitization is much more than a funding transaction because it also transfers asset-risk to the funder. In this context, Mr. Jeffrey's suggestion that a securitization under IAS be accounted for by recognizing that the asset-backed bonds can only be repaid from the proceeds of the assets is an excellent one.[13] This would mean, in effect, that the only asset remaining for the account of the company is the net asset (i.e., securitized asset less funding) and it is this asset that should be recognized on the balance sheet. This approach recognizes that the level of assets which the company has at risk has been reduced. Thus, the funding and associated assets are taken off the balance sheet, whether or not a sale has been recognized technically. As Mr. Jeffrey points out, this approach does not bring forward profits as U.S. GAAP does, and is also more conservative insofar as it does not assume that in-

9. Jeffrey notes that, "Most commentators agree that an off-balance sheet securitization is not possible under IAS because of SIC 12." *Id.* at 348.

10. *Id.* at 350.

11. *Id.*

12. *Id.*

13. *Id.*

come has been recognized from the transfer of the securitized assets on account of future cash flows.[14]

I agree with Mr. Jeffrey that the above approach would be preferable to the approach now in effect of the International Accounting Standards Board (IASB).[15] If the IASB chooses not to adopt either U.S. GAAP or the above discussed more conservative approach, then at the very least the IASB should adopt the U.K. GAAP approach. That approach recognizes in a similar fashion the changes in risk and reward profile brought about by a securitization.[16]

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14. *Id.*

15. 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.

16. Jeffrey, *supra* note 1, at 344–45.