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Standard-Setting Issues and Academic Research Related to the Accounting for Financial Asset Transfers

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SYNOPSIS: A large number and cross-section of firms undertake financial asset transfers. The Financial Accounting Standards Board and the International Accounting Standards Board have been grappling with the appropriate accounting for financial asset transfers, especially with respect to derecognition—that is, when the assets should be removed from the transferor's balance sheet. This paper discusses the financial reporting issues surrounding financial asset transfers and summarizes the related academic research. It also discusses potentially useful future research that could provide insights for standard-setters and suggests some impediments to that research.

INTRODUCTION

This paper describes financial reporting standard-setting issues associated with the accounting for transfers of financial assets, summarizes some findings of related academic research, and links those research findings to the standard-setting issues.[1] The paper also discusses unresolved financial reporting issues in the accounting for transfers of financial assets where academic research might provide insights that could prove useful to standard-setters, and identifies some potential impediments to that research.

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[1] The paper is not intended to be a review of the research on financial asset derecognition. We discuss examples of academic research with findings that have implications for setting accounting standards for financial asset derecognition, or by authors who draw standard-setting inferences.

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The threshold standard-setting issue in the accounting for transfers of financial assets is derecognition; that is, whether and under what conditions the assets should be removed from the transferor's balance sheet. Resolution of this issue has both conceptual and practical implications, including significant implications for international convergence of accounting standards and practices. With regard to conceptual issues, as part of a joint project to complete, improve, and converge their respective conceptual frameworks, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have identified derecognition as a significant and recurring conceptual issue (Bullen and Crook 2005). The FASB and IASB have isolated the following questions that are pertinent to financial asset derecognition: (1) Is derecognition simply the opposite of recognition (derecognition of an asset is appropriate when an item no longer meets the definition and recognition criteria for an asset), or should other considerations, including the ownership history of the item, affect derecognition? (2) Should derecognition of a financial asset be based on transfer of legal ownership, on surrender of control, or on transfer of substantially all risks and rewards? (3) Should derecognition focus on the asset as a whole or on its components? (4) How does derecognition interact with the choice of measurement attributes?

The issue of financial asset derecognition has been debated for many years, but standard-setters have not reached a satisfactory and durable solution. The FASB has addressed financial asset derecognition in Statement Nos. 77, 125, and 140, and has undergone a project to amend Statement No. 140. The IASB has amended IAS No. 39 several times. Both boards have acknowledged needs for improvements in both conceptual and standards-level guidance for asset derecognition.[2] In addition, and as discussed in more detail in later sections, the existing authoritative guidance for financial asset derecognition, as well as certain proposals for improving that guidance, appear to be based on divergent concepts and approaches. Specifically, Statement No. 140 is based on the surrender of control, while the approach taken in IAS No. 39 is based on the transfer of substantially all risks and rewards. Finally, in addition to the approaches taken in Statement No. 140 and IAS No. 39, the Financial Instruments Joint Working Group (JWG) has proposed an approach that analyzes a financial asset transfer in terms of components: The transferor accounts for the rights and obligations that it retains and derecognizes transferred rights and obligations.[3]

This paper proceeds as follows. The following section summarizes accounting issues related to financial asset transfers and shows how FASB and IASB have (for the time being) resolved those issues. The next section summarizes some findings of academic research that is motivated by issues surrounding financial asset transfers and discusses the standard-setting implications of the research. The concluding section raises questions that academic research might address to help standard-setters resolve open issues in the accounting for financial asset transfers.

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2 The February 27, 2006, Memorandum of Understanding (MOU) between FASB and the IASB concerning their joint international convergence efforts lists derecognition as a topic that is being researched but is not on either board's active agenda; a due-process document summarizing the results of staff research efforts is expected in 2008. The MOU is available at FASB's website (http://www.fasb.org).

3 See Financial Accounting Standards Board (2000). The Financial Instruments Joint Working Group (JWG), formed in 1997 and including representatives from the International Accounting Standards Committee (the predecessor to the IASB) and from standard-setters and professional organizations in 13 countries including the United States, has provided a research report that suggests derecognition principles for transferred financial assets. Because we believe the JWG's proposals are likely to be considered by FASB and the IASB if they undertake a joint project to improve and converge the accounting for transfers of financial assets, we discuss some of those proposals.

ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS

Derecognition is the Basic Accounting Issue

In a transfer of financial assets, one basic accounting question arises: Under what conditions should the transfer cause derecognition (removal of the asset from the transferor's balance sheet)? The answer to this question has significant practical implications, because a transfer of financial assets can be accounted for either as a sale or as a secured borrowing. While the *economic outcomes* of asset sales and secured borrowings are frequently similar, the *accounting depictions* differ greatly.[4] If the transfer is accounted for as a sale, then the transferor removes the asset from its balance sheet and reports a gain or loss, calculated as the difference between the sale proceeds and the book value of the asset sold. If the transfer is accounted for as a secured borrowing, then the financial assets remain on the balance sheet, and the transferor recognizes a liability for the proceeds.

While *nonfinancial* asset transfers also give rise to difficult accounting issues (e.g., lease accounting, sales of real estate, and revenue recognition generally), accounting issues related to transfers of *financial* assets are particularly affected by certain distinguishing characteristics of those assets. First, many financial assets appear in large homogeneous pools that are almost wholly passive (in the sense that no operating decisions must be made in order to realize the cash flows of the assets).[5] This characteristic raises the possibility that control of the assets, in the sense of decision-making powers, might not be pertinent. Second, financial assets, whether one at a time or in large pools, readily lend themselves to subdivision into components (e.g., principal versus interest on loans), raising the possibility that a part or component of a financial asset could be derecognized. Third, some financial assets are readily available and fungible, and can therefore be (effectively) lent to a transferee that can easily dispose of the assets and repurchase them when it is time to return the assets to the transferor. This characteristic raises the question of whether the ownership history of the asset, in combination with whether it is readily available, should affect the accounting for a transfer of that asset.[6]

Fourth, and related to their other characteristics, it is easy to modify financial assets as part of the transfer.[7] Modifications vary in the extent to which they introduce a new party to the arrangement, other than the transferor and the transferee(s), and in the extent to which they could require a party to the arrangement to pay cash, as opposed to forgoing a cash receipt. Modifications in the form of derivatives and guarantees offset a risk that exists in the transferred asset, introduce a new risk—counterparty performance—and introduce the possibility that cash flows paid to investors in the transferred assets may come from sources other than the transferred assets themselves. In contrast, modifications in the form

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[4] That is, the payoffs to the transferor and the investors in the financial assets can be similar for asset sales and secured borrowings. In a secured borrowing the borrower "reacquires" the collateral when it is released, after the debt is settled. In the case of financial assets as collateral, most or even all of the cash flows of those assets might have been realized by the time the debt is settled. The outcome of a secured borrowing is similar to that of an asset sale to the extent that the borrower has transferred for consideration (the use of investors' cash) most or all of the cash flows of the asset that serves as collateral.

[5] However, this is not universally the case; some financial assets such as put or call options *require* the holder to make decisions and some, such as equity instruments with voting rights, *permit* decisions.

[6] Paragraph 32 of Statement No. 140 indicates that an option to reacquire assets that are readily available might not preclude sale accounting (depending on other terms), but such an option *would* preclude sale accounting if the assets are not readily available. However, ownership history also matters. That is, a transfer of an asset that is not readily available with the option to repurchase that asset would not result in derecognition, but an option to purchase an asset that had not been previously owned—regardless of whether it is readily available—would be accounted for simply as an option.

[7] Of course, nonfinancial assets can also be sold with guarantees of performance (e.g., warranties) and with other modifications such as rights of return. These modifications give rise to their own accounting complications.

of subordinated interests divide (as opposed to offset) a risk that exists in the transferred assets, introducing no new risks and no new sources of cash flows (because the holder of the subordinated interest is exposed to receiving no cash, as opposed to paying cash). The relative ease of modification, as well as the many possible forms of modifications, raises the question as to whether the *characteristics* of modifications of financial assets, made as part of transfers of those assets, should affect the accounting for the transfers.

U.S. GAAP Requirements for Financial Asset Derecognition

Statement No. 77, Reporting by Transferors of Receivables with Recourse

Statement No. 77 was issued in December 1983. Statement No. 125 was then issued in June 1996 to provide guidance for more complex transactions and to consider more types of continuing involvement than recourse. Although Statement No. 77 was superseded by Statement No. 125, we discuss Statement No. 77 because it reflects FASB's initial approach to financial asset derecognition and the handling of recourse, which is a recurring standard-setting concern and a significant focus of academic research.

Statement No. 77 applied a control approach to derecognition of financial assets, considered as indivisible units. It identified three conditions that must be met for a transfer of receivables with recourse to qualify for sale treatment: (1) The transferor surrenders control (an option to repurchase would violate this condition).[8] (2) The transferor's obligation under the recourse provisions can be reasonably estimated. (3) The transferee cannot require the transferor to purchase the receivables except pursuant to the recourse provisions. With regard to measurement, the transferor is required to apply Statement No. 5 to accrue for "probable adjustments," that is, to apply Statement No. 5's "probable" recognition threshold and measurement guidance to recognize and measure the effects of debtor defaults, prepayments, and possible legal defects in the receivables.

For our purposes, Statement No. 77 is noteworthy because it establishes the principle that recourse per se does not preclude sale accounting.[9] The principle is based on the view that loans collateralized by receivables are substantively different from transfers of receivables with recourse; in the latter arrangement (but not the former) the transferor has surrendered control of the future economic benefits of the receivables in exchange for cash, while retaining some of the risks of ownership. Recourse is merely one form of risk retention, and that alone is not enough to preclude sale accounting in Statement No. 77, as long as it is possible to reasonably estimate the effects of that risk retention per Statement No. 5 (i.e., the recourse obligation is measured as "all probable adjustments in connection with the recourse obligations to the transferor" [Statement No. 77, paragraph 6]).[10] In addition, FASB reasoned that a requirement to treat a transfer entirely as a secured borrowing if there is any risk retention would require the transferor to record as liabilities credits that do not meet the accounting definition of liabilities, because the transferor is not obligated

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[8] This condition also illustrates the effect of ownership history on the accounting for financial asset transfers; see footnote 6. Because Statement No. 77 considers transfers of receivables, the question of how the ready availability of those assets would interact with an option to reacquire does not arise.

[9] The two dissenters to Statement No. 77 argue that any form of recourse means that "the economic benefits and inherent risks related to [the] receivables ... are controlled by the transferor" because it benefits when the receivables are collected and incurs costs when they are not, while the transferee is indifferent between those two outcomes as long as it receives the promised cash. That is, the dissenters argue that recourse is sufficient to preclude derecognition of transferred assets, so that a transfer with recourse should be accounted for as a secured borrowing.

[10] Statement No. 77 does not require that recourse obligations be measured at their fair values. Statement No. 5's recognition criterion also implies that no obligations would be recognized unless and until payments under the recourse provisions become probable.

to repay a loan (the entire proceeds); it is obligated only to stand ready to perform under the recourse provisions.

Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

Statement No. 140 was issued in September 2001, replacing Statement No. 125. (Statement No. 140 carries forward many of the provisions of Statement No. 125, so we do not consider Statement No. 125 further.) Statement No. 140 uses "surrender of control" to determine whether a transfer of financial assets is a sale or a secured borrowing. Control is considered to be surrendered by the transferor if (1) the assets are isolated from the transferor and its creditors, even in bankruptcy (a legal concept); (2) the transferee has the right to pledge or exchange the assets, unless the transferee is a qualifying special purpose entity (QSPE); and (3) the transferor does not maintain effective control over the assets through certain forms of continuing involvement, including an agreement that entitles and obligates the transferor to repurchase or redeem the assets before their maturity and the ability to cause the holder to return the specific transferred assets (except for special treatment of cleanup calls, certain removal-of-accounts provisions, and certain agreements to repurchase items that are fungible and readily available).

Three features of Statement No. 140 are particularly pertinent for our discussion. First, the requirement of legal isolation (also called bankruptcy remoteness) means that the possibility that the transferor or its creditors might reclaim the transferred assets, even if the transferor were to enter receivership, is sufficient to preclude derecognition—that is, legal isolation is a *recognition condition* that does not affect measurement.[11]

An alternative, favored by the JWG, would use a measurement approach to capture the effects of legal isolation. Such an approach would measure the fair value of the transferred assets (or the claims on their cash flows) taking into account expectations about transferor or creditor claims on those assets, and would apparently permit transfers of assets that do not meet the legal isolation condition to be accounted for as sales, with the pricing of the transfer capturing the lack of legal isolation. That is, investors would presumably pay less for transferred assets that are not legally isolated. This is an example of measurement interacting with recognition. Under the requirements of Statement No. 140, the legal isolation criterion affects (de)recognition and has no explicit measurement effects, while under a measurement approach, uncertainty about potential future transferor/creditor claims on the transferred assets is captured by measurement.

Second, because of its requirement that the transferee can pledge or exchange the assets it receives, Statement No. 140 makes the transferor's accounting for a transfer of financial assets a function of the rights of the transferee. While the right of the transferee to pledge or exchange the transferred assets may constitute the ultimate evidence that the transferor has given up control, Statement No. 140's focus on that right has in turn necessitated the creation of QSPEs (discussed later in this section).

Third, in Statement No. 140, relinquishment of control clearly does not preclude all forms of continuing involvement in the asset on the part of the transferor. In practice, determining the acceptable nature and magnitude of continuing involvement has proven complex, and sometimes the determination depends in part on whether the transferred assets are readily available (refer to footnote 6).

[11] The idea of bankruptcy remoteness is not accepted in all jurisdictions. See, for example, Financial Accounting Standards Board (2000, paragraph 3.80), which states: "bankruptcy remoteness is an unfamiliar and largely untested notion in some jurisdictions."

With regard to recourse specifically, however, Statement No. 140 follows Statement No. 77: A transfer of receivables with recourse is accounted for as a sale, with the sale proceeds reduced by the fair value of the recourse obligation, if the criteria for a sale are met. That is, the transferor would derecognize the transferred receivables and net the fair value of the recourse obligation (the retained risk) against the assets received—the recourse obligation is not *separately* recognized. However, Questions 67 and 68 of FASB's 2001 *Special Report on Statement No. 140* also make it clear that the method used to provide recourse might affect the accounting for the transfer. If the recourse takes the form of subordinated retained interests (the transferor holds an interest in the transferred assets that is paid after other investors have been paid, thereby absorbing much or all of the credit risk), there is no separate recourse liability, because the cash flows to the investors derive from the transferred assets, not the transferor. Only if the transferor could be obligated to pay investors—as opposed to forgoing payments on the interests it holds—would the transferor record a recourse liability.[12]

International Accounting Standard (IAS) No. 39, *Financial Instruments: Recognition and Measurement*

The current version of IAS No. 39 (applicable for annual periods beginning on or after January 1, 2005) uses a risks-and-rewards approach to financial asset derecognition. Specifically, asset derecognition is determined based on the transfer of "substantially all the risks and rewards of ownership," evaluated by analyzing whether the transferor's post-transfer exposure to the variability in amounts and timing of the cash flows of the transferred assets is "no longer significant in relation to the total variability" of those cash flows (paragraphs 20 and 21).

IAS No. 39 requires risk-and-reward analysis that focuses on the total variation of outcomes (considering both upside rewards and downside risks). That analysis necessitates the quantification and comparison of the various types of risk and reward inherent in financial assets, including the risk/reward associated with changes in interest rates and foreign currency exchange rates, as well as changes in default risk and prepayment risk. IAS No. 39 does not specify the procedures to be used in this analysis. For example, the standard stipulates that "all reasonably possible variability" is to be considered (paragraph 22), but does not state whether the variability to be analyzed is the *maximum* amount, the *expected* amount, or something else, and it does not provide guidance for determining what is a "significant" exposure to variability. In its discussion of approaches considered but not adopted in the development of Statement No. 125, FASB identified the requirement to quantify and compare the various types of risk and reward and the difficulties in determining when the threshold of "substantially all" has been met as reasons for rejecting a risks-and-rewards approach in favor of a control-based approach.[13]

IAS No. 39 is likely to differ from Statement No. 140 in its application for at least two reasons. First, the determination of the transferor's accounting in a risks-and-rewards

[12] Casual observation of recent financial asset transfer arrangements suggests that subordination is more commonly used than recourse.

[13] Those who favor a risks-and-rewards approach as being principles-based may wish to consider Statement No. 13, *Accounting for Leases*, often characterized as being highly rules-based. The basis for conclusions of Statement No. 13 (paragraph 60) makes it clear that FASB created the provisions of the statement to make operational the view that "a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee." Similarly, Interpretation No. 46(R), *Consolidation of Variable Interest Entities, An Interpretation of ARB No. 51*, which uses risks and benefits as the determinants of consolidation (paragraph E7), has been criticized for being rules-based and difficult to apply.

framework is not based on what the transferee can do with the transferred assets. Therefore, IAS No. 39 does not explicitly specify a QSPE arrangement to permit sale treatment for transfers to wholly passive entities that (1) are expected to hold passive financial assets for the benefit of investors and (2) will not be consolidated by the transferor.[14] (IAS No. 39 requires a consolidation analysis before the application of derecognition criteria, while QSPEs are exempted from the provisions of Interpretation No. 46[R].) Second, IAS No. 39 is based on a consideration of all transferred and retained risks and rewards, so it does not require a separate consideration of legal isolation or of all forms of continuing involvement, including the possibility that the transferor or its creditors might be able to reclaim the transferred assets, since these would presumably be part of the analysis of retained risks and rewards.

Vexatious and Recurring Financial Reporting Issues

Distinctions between Control Approaches and Risk-and-Reward Approaches

To achieve international convergence of financial reporting standards for transfers of financial assets, standard-setters will have to resolve the differences between the approaches in Statement No. 140 and IAS No. 39.[15] Those approaches may at first appear to be so different as to be nearly irreconcilable; however, closer analysis reveals they are distinct, but related. For example, control of an asset is neither necessary nor sufficient to receive some or all of the risk and reward of that asset, because (at the cost of introducing the risk of counterparty performance) a derivative can be used to shift some or all of either or both the risk and reward of an asset to a party that has no ownership claim on that asset. On the other hand, control without access to some or all of the risk and reward of an asset is probably meaningless (the party in apparent control may be a fiduciary). This analysis suggests that risk and reward may overlap with control, or that control may be fundamental to risk and reward (the payoff structure that is captured by the risk and reward of an asset is what makes control valuable).

Derecognition of Pieces (Components) of a Financial Asset

In its simplest form, a components approach would require transferors and transferees to recognize and measure, after a transfer of financial assets, the financial statement elements (assets, liabilities, revenues, and expenses) each has as a result of the transfer. For example, a transferor would derecognize any transferred components that qualify as assets and continue to recognize any retained components that qualify as assets.

While both Statement No. 140 and IAS No. 39 are partly based on a components approach, neither standard completely resolves the treatment of pieces (components) of financial assets. For example, Statement No. 140's legal isolation criterion might seem to apply to whole assets—that is, the whole asset must first be legally isolated in order for

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[14] However, paragraph 19 of IAS No. 39 describes a passive pass-through entity that is similar to a QSPE. In addition, if the risks-and-rewards analysis is not determinative (i.e., the transferor has neither transferred nor retained substantially all the risks and rewards of the transferred asset), IAS No. 39 requires that the accounting treatment be determined by whether the transferor has retained control of the asset. IAS No. 39's control analysis (paragraph 23) rests on the ability of the transferee to sell the transferred asset.

[15] Statement No. 140 and IAS No. 39 could require different accounting treatments for the same arrangement. For example, suppose that a transferor transfers financial assets that are not readily available to an investor for cash and enters into a contract with the investor to repurchase the financial assets in six months at their fair value. Because the assets are not readily available, the investor is restricted in its ability to sell or otherwise transfer the financial assets. Under Statement No. 140's control approach, the transferor would not derecognize the financial assets. However, the transferor's agreement to repurchase the financial assets at fair value would appear to transfer the risks and rewards of those assets to the investor, suggesting that the application of IAS No. 39 would result in the transferor derecognizing the transferred financial assets.

any piece of that asset to qualify for derecognition.[16] Similarly, IAS No. 39 requires an initial determination of whether its sale criteria are to be applied to the entire asset or to certain specified parts (which need not be *pro rata*). In addition, agreement may not be reached as to what constitutes a ‘‘component’’ of an asset that might qualify for separate derecognition.[17] For example, must a component be present in the original transferred asset (e.g., a subordinated interest) or can it be added in connection with the transfer (e.g., a guarantee)?

Ownership History of the Asset

The issue of ownership history arises when the transferor has continuing involvement in the form of an opportunity to reacquire a transferred asset, for example, a fixed-price call option. While a fixed-price option that entitles the holder to acquire an asset it has never owned would be accounted for simply as a call option (asset), if that option pertains to a transferred financial asset, Statement No. 140 requires an analysis of the details of the arrangement and the institutional features of the marketplace for the asset, including whether it is fungible and readily available (e.g., paragraph 32). That is, ownership history affects the accounting.

In contrast, IAS No. 39 would focus on the transferor's retention of downside risks and upside rewards. A transferor that holds a fixed-price call option to repurchase a transferred asset has upside rewards to the extent the asset's price is above the strike price, and its downside risk is limited to the loss of the option premium. Under IAS No. 39, if the call option has caused the transferor to retain substantially all the risks and rewards of ownership, then the asset would not be derecognized. If the transferor has neither transferred nor retained substantially all the risks and rewards of ownership and has retained control, then it would recognize ‘‘the transferred asset to the extent of its continuing involvement’’ (paragraph 30). Finally, a pure components approach would, presumably, focus only on the right retained by the entity (the call option) and would not record the underlying transferred asset.

Transfers to a Passive Transferee that Cannot Pledge or Exchange the Transferred Asset

To protect investors in the cash flows that will be generated by passive financial assets, it may be necessary to transfer those assets to a passive transferee that cannot dispose of the assets. Because a transfer to a transferee that cannot dispose of the transferred assets would fail one of the sale criteria in Statement No. 140, FASB created an exception for qualifying special purpose entity (QSPE) transferees. The FASB intended the QSPE to be a structure that is so passive that control of it cannot be an issue; it was intended to be a ‘‘pass-through’’ vehicle holding assets that require no decision-making, for the benefit of investors in those assets. However, the passivity of such a structure can never be absolute (for example, if debtors default, then some action must be taken to protect the structure's investors), so FASB has found it necessary, on more than one occasion, to reconsider the limits of permitted activities of QSPEs.

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[16] The question of whether, and under what conditions, a piece of a financial asset can be derecognized by a transferor without first legally isolating the entire asset is part of FASB's current project on transfers of financial assets (as of August 2006).

[17] At least two approaches to defining components of financial assets might be considered. One approach would build on the ideas in FASB's 2000 Exposure Draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equities or Both*, which defined six basic components of financial instruments (unconditional and conditional payables and receivables, options, guarantees, forwards, and equity). Another approach would define components of an asset as ‘‘rights and obligations (i.e., assets and liabilities) embedded in that asset.’’

In addition, although IAS No. 39 does not explicitly contain the notion of a QSPE, the standard does describe (paragraph 19) an entity that receives cash flows of an asset, has a contractual obligation to pay those cash flows to others—with that obligation limited to the cash flows from the original asset, and cannot sell/pledge the original asset. Therefore, it would appear that the IASB also found it necessary to create a passive transferee that would not be able to dispose of transferred assets but whose presence in an arrangement would not preclude sale accounting.

Measuring the Gain or Loss on a Sale of Financial Assets

A transferor often retains one or more interests in transferred financial assets, for example, to monitor and service the assets (servicing rights) or to protect the transferee from some amount of credit risk (subordinated interests). Both Statement No. 140 and IAS No. 39 require an allocation of the carrying value of the transferred assets between the assets sold and the retained interests, based on their relative fair values.[18] A gain or loss is reported for the assets sold, while no gain or loss is reported for the retained interest(s). Frequently, no markets for the retained interests can be observed, so the relative fair values that determine gain or loss must often be measured using valuation techniques. That measurement requires professional judgment, which has been viewed by some (including academic researchers) as allowing the possibility of manipulations.

RESEARCH ON ACCOUNTING ISSUES RELATED TO TRANSFERS OF FINANCIAL ASSETS

Academic research on transfers of financial assets has provided direct and indirect evidence that standard-setters might find useful as they attempt to converge and improve the accounting guidance for financial asset transfers. However, research has addressed only a limited subset of the issues that standard-setters seek to resolve. Specifically, research has addressed: (1) the magnitude of financial asset transfers and their impact on financial statements; (2) motives for financial asset transfers; (3) motives for, and prevalence of, recourse in financial asset transfers; (4) investor treatment of financial asset transfers; and (5) transferor responses to changes in accounting standards for financial asset transfers. Because banks are heavily involved in securitizing financial assets, a significant portion of this research considers issues that are specific to banks, such as regulatory capital considerations. In this section, we summarize research findings that pertain to each of these issues, discuss potential standard-setting implications, note research limitations that could reduce its usefulness to standard-setters, and provide suggestions for future research.

Three general limitations apply to most or all of the research we consider. First, the research uses archival data that reflect outcomes reported under the accounting and regulatory guidance in force at the time the outcomes occurred. Findings based on analyses of different time periods with different accounting standards and regulatory requirements may not apply to the current environment. Second, the research often aggregates, for purposes of analysis, financial asset transfers with different structures and characteristics, without controlling for differences that could have both accounting and regulatory implications. Third, to the extent the research is descriptive, it is difficult to detect important relations between the variables. In addition to these general limitations, we also note specific limitations as applicable.

[18] For years beginning after September 15, 2006, Statement No. 156, *Accounting for Servicing of Financial Assets*, an amendment of FASB Statement No. 140, requires initial measurement of servicing rights at fair value, not allocated carrying value, and permits (but does not require) subsequent measurement at fair value.

The Magnitude of Financial Asset Transfers and Their Financial Statement Impact

Based on an analysis of the financial statements, footnotes, and management discussion of 200 issuers, the Securities and Exchange Commission (SEC) estimates that about 5.3 percent of active U.S. issuers (i.e., SEC registrants) reported transfers of financial assets at the end of 2003, and that $1 trillion in financial assets were transferred and removed from the transferors' balance sheets but were still outstanding at the end of 2003 (SEC 2005).[19] This evidence indicates that financial asset transfers are economically significant, albeit undertaken by less than 10 percent of U.S. public entities. Research also suggests that securitization activities are concentrated among financial services firms, but other sectors are also involved. Based on an examination of 127 10-K filings that disclose details on securitizations from September 2000 to December 2002, Dechow et al. (2005) find that approximately 30 percent of the sample represents nonfinancial firms, including the retail, manufacturing, and real estate industries.

Niu and Richardson (2006) examine 535 securitization disclosures from 1997 to 2003, and find that the average outstanding amount of transferred receivables minus the related credit enhancements (retained interests) is about 4.3 times the market value of equity of the transferors. For their sample, the mean debt-to-equity ratio of 5.9 reported using sale accounting would have increased to 10.2 had the transferors accounted for the transfers as secured borrowings. This evidence points to economically significant differences in leverage ratios depending on whether transfers of financial assets are accounted for as sales or secured borrowings.

To summarize, research suggests that the accounting for financial asset transfers affects a significant number of firms, in various industries, with concentration in financial services, retailing, real estate, and manufacturing. In addition, the dollar magnitude of financial transfer activities is significant, and differences in accounting treatment have substantial effects on leverage ratios.

Motivations for Financial Asset Transfers

Motivations for financial asset transfers—selling and securitizing financial assets—can be divided into two distinct types. First, motivations may be unrelated to accounting treatments, and may include economic reasons such as diversifying an asset pool, focusing on competitive advantage, and obtaining liquidity for future growth. Securitizations, in particular, are attractive to firms seeking nonequity capital on favorable terms because they isolate securitized assets in bankruptcy and create separate financial assets with varying risk characteristics to satisfy investors with different risk preferences. The second type of motivation is associated with the sale (derecognition) treatment permitted certain financial asset transfers. Accounting for a transfer of financial assets as a sale provides a means to reduce regulatory capital and to manage earnings. Research has provided evidence supporting each of these motivations.

Economic Motivations for Financial Asset Transfers

Researchers have found evidence indicating that firms sell and securitize assets to diversify, to focus their efforts on activities in which they have competitive advantages, and to meet liquidity needs. Pavel and Phillis (1987) find that banks that sell or securitize loans have higher loan concentrations and, therefore, greater needs for asset diversification than

[19] The SEC examined the financial statements and disclosures of the 100 largest issuers (based on market capitalization on December 31, 2003) and 100 additional randomly selected issuers. The SEC excluded Fannie Mae and Freddie Mac because they are government-sponsored entities.

other banks. In addition, both Pavel and Phillis (1987) and Karaoglu (2005) find that banks are more likely to sell loans if they have a lower ratio of non-interest expense-to-total loans, suggesting that banks that sell loans more efficiently originate loans. Finally, in terms of meeting liquidity needs, Karaoglu (2005) finds that banks that sell or securitize loans have a higher loan-to-deposit ratio, higher growth expectations as measured by the market-to-book ratio, and stronger motives to avoid underinvestment as measured by the interaction between the market-to-book ratio and debt-to-equity ratio.

Because securitizations separate financial assets by risk characteristics to satisfy investors with different risk preferences, they reduce financing costs and thereby facilitate access to nonequity capital. Minton et al. (2004) point out that the sale and securitization of low-risk assets should lead to lower financing costs since riskier assets are more likely to be discounted by relatively uninformed investors. Consistent with this motivation, Pavel and Phillis (1987) and Ambrose et al. (2004) find that firms tend to sell and securitize their higher quality assets and retain their lower quality assets.

Gorton and Souleles (2005) suggest that securitizations reduce financing costs by isolating securitized assets from the expensive and lengthy bankruptcy process. Consistent with this reasoning, they find that riskier firms are more likely to securitize. Similarly, Minton et al. (2004) find that unregulated financial companies become more likely to securitize with increased leverage. Examining the effect of LTV Steel's bankruptcy, in which a securitization was recharacterized as a secured loan, Ayotte and Gaon (2005) find that spreads for asset-backed securities issued by transferors eligible for Chapter 11 bankruptcy increased significantly more than spreads for securities of transferors not eligible for Chapter 11 bankruptcy around LTV's bankruptcy announcement. Consistent with the importance placed on legal isolation in Statement No. 140, they conclude that "the creditor protection provided by bankruptcy remoteness is indeed valuable and priced in financial markets" (Ayotte and Gaon 2005, 1).

We interpret this research as providing evidence that financial asset transfers are economically substantive, in the sense of being undertaken to provide real economic benefits. We note that legal isolation appears to be an important element in obtaining these benefits, consistent with the emphasis placed on this condition in Statement No. 140. However, research results do not illuminate whether the measurement approach to legal isolation (suggested by the JWG) might be superior to the recognition approach taken in Statement No. 140.

Accounting-Based Motivations for Financial Asset Transfers

Management of bank regulatory capital. Financial asset transfers are often undertaken by regulated banks that are required to meet certain regulatory capital requirements. Those requirements are generally based on both reported (recognized) assets and exposures to off-balance sheet activities. Because of the significant balance sheet impact of sale treatment, as opposed to secured borrowing treatment, banks might securitize assets to manage their regulatory capital.[20] However, research does not support the view that bank securitizations are primarily motivated by the desire to *minimize* regulatory capital. Minton et al. (2004) find that commercial banks are *less* likely to securitize than unregulated firms and

[20] Banks are required to maintain regulatory capital greater than a specified percentage of risk-weighted assets, computed as the sum of balance sheet assets and direct credit exposures from off-balance sheet activities, weighted according to their risk levels. For example, bank regulators require minimum capital based on a combination of leverage ratios and risk-based capital ratios. The maximum leverage requirement is determined as a fraction of total assets, and there is a risk-based capital requirement in which tier 1 (tier 1 plus tier 2) capital as a percentage of risk-weighted assets must be greater than 0.04 (0.08).

that banks with lower capital ratios are less likely to securitize than banks with higher capital ratios.

On the other hand, securitizations might be motivated by the desire to manage regulatory capital requirements in other ways—specifically, to hold assets whose risk characteristics are commensurate with capital requirements. Nolan (2005, 4) notes that in calculating required capital ratios, prior to 2002, the risk weighting ''was based exclusively on the so called 'standardized risk bucket approach' which assigns risk weightings to different categories of assets without distinguishing among different levels of risk within a single asset category based on the relative credit worthiness of the obligor.'' In addition, Nolan (2005) notes that the required capital on residual interests was limited to a 100 percent risk weighting.

Some argue that the failure to distinguish levels of risks, combined with the risk weighting handling of residual interests, creates an opportunity for regulatory arbitrage through securitizations. Consistent with results in Pavel and Phillis (1987) and Ambrose et al. (2004) that banks securitize safer loans and retain riskier ones, Minton et al. (2004, 8) suggest that a securitizing bank may wish to hold ''high risk assets because the low risk assets require the bank to hold more capital at the margin than is economically justified by their incremental effect on the probability of insolvency.''

However, the retention of risky financial assets is also consistent with a desire to reduce financing costs by retaining the assets most likely to be discounted by investors, so this research does not unambiguously support the inference that bank securitizations are motivated by regulatory capital arbitrage. In addition, recent (and proposed) changes in regulatory capital rules better align the risk weightings with their actual risk levels and place additional restrictions on the treatment of retained interests, reducing both the opportunities and incentives for regulatory capital arbitrage.

Earnings management. Similar to sales of available-for-sale financial instruments and nonfinancial assets, financial asset sales and securitizations can be timed to manage earnings. Karaoglu (2005) examines loan sales and securitizations, noting that both arrangements allow discretion in the timing and the selection of loans to be transferred that could be used to manage earnings. Consistent with this earnings management perspective, he finds that banks are more likely to *sell* loans when their pre-transfer income does not meet analyst forecasts or prior-year earnings. However (and not consistent with an earnings management perspective), he finds no relation between the decision to *securitize* loans and meeting analyst forecasts and prior-year earnings.

Karaoglu (2005) also notes that accounting for securitizations requires more professional judgment and estimation than does accounting for loan sales, because, in a securitization, managers not only decide when to transfer assets and which assets to transfer, but also calculate a gain or loss based on the fair value of the retained interest. As previously discussed, both Statement No. 140 and IAS No. 39 require that retained interests in securitized assets be measured by allocating the carrying value of the transferred assets between the assets sold and the retained interests based on their relative fair values, which typically must be estimated. Therefore, under current accounting standards, a gain or loss is reported for the assets sold, but not for the retained interests, and the fair value estimates affect the magnitude of that reported gain or loss.

Although some (e.g., the American Accounting Association's Financial Accounting Standards Committee [AAA 1996]) argue that a transfer of financial assets that does not change the fundamental attributes of those assets should not result in any gain or loss, research has documented that transfers of financial assets usually result in reported gains.

Specifically, Dechow et al. (2005) find that 76 percent of firms report gains, 14 percent report no gain or loss, and 10 percent report losses from securitizations. They do not investigate whether transferors modify the transferred assets but focus, instead, on measurement issues. Specifically, they note differences between fair values and book values and, therefore, that reported gains may be due to the use of internal discount rates, not market rates, to discount the cash flows from the assets.

Consistent with the view that securitizations are used to manage earnings, Shakespeare (2004) finds evidence that firms manage retained-interest fair-value estimates to meet analyst forecasts and prior years earnings; Dechow et al. (2005) find that firms are more likely to report large securitization gains when income is low or below the previous year's income; Dechow and Shakespeare (2006) find that the reporting of gains or losses from securitization transactions appears to be influenced by financial reporting incentives (e.g., to exceed the previous year's income or analyst forecasts); and Karaoglu (2005) finds that securitization gains are negatively related to the change in earnings before securitization gains. In addition, Karaoglu (2005) finds less earnings management related to mortgage securitizations than to other securitizations. He argues that firms are more likely to manage earnings related to nonmortgage securitizations because they are less likely to have established market values and therefore more likely to offer opportunities to manipulate fair value estimates.

In addition to earnings management incentives, Dechow and Shakespeare (2006) argue that firms have timing incentives to arrange securitizations just before a financial reporting date in order to increase efficiency ratios, decrease leverage ratios, and increase reported operating cash flows. Consistent with this view, the authors find that securitization transactions occur with greater frequency in the last few days of each month and in the last few days of each quarter. On the other hand, the timing of these transactions, taken alone, does not necessarily call into question either the economic validity of the transactions or the way they are reported.

Implications of this research. This research may be interpreted in at least two ways. First, standard-setters should consider the potential for earnings and balance sheet management in establishing accounting standards for financial asset transfers. Second, managers, auditors, and other participants in the financial reporting process, including audit committees and regulatory bodies, should be concerned about how those standards are implemented. For example, Karaoglu (2005, 25) concludes that the evidence of biased reporting raises concerns about "the reliability of the reported fair values in the absence of liquid markets that provide reference prices," and Dechow et al. (2005, 28) suggest that standard-setters should consider "limiting management's flexibility in using their internal costs of capital in determining the value of retained interests."

We believe that, in this case, the earnings management behavior documented by research arises from management's implementation decisions, and not from the standards themselves, so we do not believe that research provides evidence of a need for additional standards governing the measurement of fair values in transfers of financial assets. Our conclusion rests on two bases. First, Statement No. 140 requires a fair value measurement, and the objective of that measurement is stated in FASB's conceptual framework. That is, Statement of Financial Accounting Concepts (SFAC) No. 7 states that fair value is calculated using estimates and expectations that marketplace participants would use in determining the amount at which an asset could be bought or sold in a current transaction between willing parties. Therefore, an implementation of Statement No. 140 that uses an internal discount rate that is not consistent with market participant estimates and expectations to estimate the fair value of retained interests would not be consistent with a fair value measurement objective, and would therefore be an improper implementation of the standard.[21] Second, Dechow et al. (2005) find that firms with less powerful CEOs and more outside monitoring are less likely to manage earnings through securitizations, suggesting that appropriate governance arrangements would curtail this abuse.

We believe that the financial asset transfer issues identified by academic research can be addressed by properly applying existing standards and through appropriate governance. We also believe that these issues raise two more general standard-setting questions. First, what should a standard-setter assume about the implementation of standards (and what evidence should the standard-setter gather to form those assumptions)? Second, when are implementation issues sufficiently serious to warrant a review and possible changes to the standard?

Motives for, and Prevalence of, Recourse in Financial Asset Transfers

Background. As previously discussed, Statement No. 140 and IAS No. 39 specify criteria to determine if a transferor of financial assets has surrendered control (Statement No. 140) or transferred substantially all the risks and rewards (IAS No. 39) of those assets and should treat the transfer as a sale. In making that determination, both Statement No. 140 and IAS No. 39 permit some continuing involvement. That is, IAS No. 39 (paragraph 21) requires that the transferor's post-transfer exposure to cash flow variability "is no longer significant in relation to the total variability" of those cash flows, so a fair value call option or a retention of a *pro rata* share would be permitted, and Statement No. 140 describes several forms of permissible continuing involvement.

Recourse is among the forms of continuing involvement permitted by Statement No. 140, provided the assets are deemed to be isolated from the transferor under applicable laws and regulations. If a transfer of financial assets with recourse meets the conditions for the surrender of control, then the transfer can be accounted for as a sale with any gain recognized on the sale reduced by the fair value of the recourse obligation. (That is, the fair value of the recourse obligation is accounted for but not as a separate obligation; it is included *net* with the rest of the arrangement.) As previously discussed, FASB has made it clear, beginning with Statement No. 77, that it does not equate recourse with control.

Although existing accounting guidance does not view recourse *per se* as an impediment to sale accounting for financial asset transfers, researchers have focused on this form of continuing involvement. In fact, we could not find any research on other forms of continuing involvement. In addition, research has focused specifically on noncontractual (i.e., implicit) recourse, arguing that transfers of financial assets sometimes include an unstated promise that the transferor will provide an unspecified amount of recourse. Those researchers argue that the balance sheet of a transferor that provides implicit recourse but accounts for the transfer as a sale does not display all the transferor's risks and obligations related to the transferred assets.[22] As result of the nonrecognition of implicit recourse, these researchers say, investors might be misled and regulatory capital might be inadequate.

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[21] In addition, paragraph 68 of Statement No. 140 describes fair value in terms of a current transaction amount, for which the best evidence is a quoted price in an active market, and paragraph 69 specifies that when measurement techniques are used, the techniques "should incorporate assumptions that market participants would use." This point is reinforced by EITF D-69, *Gain Recognition on Transfers of Financial Assets under FASB Statement No. 140*, which emphasizes that "using assumptions that are not consistent with current market conditions in order to ascribe intentionally low or high values ... is not appropriate" (paragraph 2).

[22] It is not clear whether these researchers mean the (implicit) recourse obligation should be, but is not, displayed or disclosed separately instead of being netted against the proceeds of the transfer, or whether they mean that the (implicit) recourse obligation is omitted from the accounting altogether.

Evidence on the prevalence of implicit recourse. Calomiris and Mason (2004) note that since 1996 regulators have expressed concerns about the provision of implicit recourse and have issued guidance as to examples of actions that provide implicit recourse. However, they argue that the practice continues and provide examples of implicit recourse as late as 2003.

Higgins and Mason (2004) also argue that transferors provide implicit recourse and document 17 recourse events involving ten credit card banks, based on a search of Lexis-Nexis from 1987 to 2001 for reports of ''ratings affirmations'' following a period of weak collateral pool performance. The recourse events involve adding new, higher quality accounts, selling new receivables to the pool at a discount to par, increasing the credit enhancement, getting investors to waive early amortization triggers, and getting the servicer to reduce its fees. The authors also note that during 1987 to 2001, only two credit card securitizations entered early amortization without recourse.[23]

Motives for providing implicit recourse. Calomiris and Mason (2004) suggest that transferors may securitize with implicit recourse either to generate and exploit subsidies from government safety nets (i.e., deposit insurance) or to allocate risk and capital more efficiently. They examine securitizations without explicit recourse to provide evidence on each motivation.

The safety net motivation implies that securitizing banks that provide implicit recourse transfer some of the associated risk to the government via deposit insurance, an outcome that some would view as socially undesirable. Empirically, the safety net motivation implies that securitizing banks' capital levels should be close to the minimum regulatory requirements. Calomiris and Mason (2004), however, find that capital levels of securitizing banks exceed regulatory requirements, and they have equal or higher capital ratios than nonsecuritizing banks. They suggest, therefore, that banks' provision of implicit recourse is not motivated by governmental safety nets.

The use of implicit recourse to allocate capital and risk more efficiently presumes that bank managers and investors believe that capital regulatory requirements are too high, given the risks of the related assets. Obtaining external financing by transferring assets with implicit recourse is cheaper than issuing equity or transferring assets without implicit recourse; therefore, healthy banks with scarce resources would reap the greatest benefits from transfers with implicit recourse. In addition, if investor demand drives the use of transfers with implicit recourse, then transferring banks' capital should vary with the market perceptions of on- and off-balance sheet asset risks.

Consistent with this analysis, Calomiris and Mason (2004) find that securitizing banks maintain lower capital ratios (relative to on- and off-balance sheet assets) than do nonsecuritizing banks, and that securitizing banks' capital is better explained by the managed capital ratios (relative to on-balance sheet assets plus off-balance sheet securitized assets) than the regulatory capital ratios (relative to on-balance sheet assets). Therefore, securitizing banks are able to reduce their capital (relative to assets) below the levels that would be required if the assets remained on the banks' balance sheets. The evidence suggests that investors believe that lower capital is adequate. The authors conclude that ''this implies that the amount of capital needed to stand behind securitized receivables should be less than the amount needed to stand behind receivables held on the balance sheet'' (Calomiris

[23] Early amortization occurs when collateral is underperforming. Instead of purchasing new collateral from the sponsor through the designated time period, the SPE makes payments to investors in order to prevent the loss of principal.

and Mason 2004, 20). Therefore, securitizing with implicit recourse appears to be motivated by the wish to save required regulatory capital and maintain capital levels consistent with market perceptions of risk.

Gorton and Souleles (2005) suggest that transferors that plan to return to the market for financing at a later point must support current asset transfers by providing implicit recourse. The authors examine 167 credit card asset-backed securities issued between 1988 and 1999. Consistent with this theory, they find a positive relation between the yields for bonds issued by trusts (SPEs) and the risk of the sponsors, suggesting that sponsor risk is related to the pricing of the SPE debt. However, this relation is documented for arrangements prior to the issuance of Statement No. 140.

Characteristics of recourse providers. Higgins and Mason (2004) provide evidence on characteristics of transferors that provide recourse by examining stock returns and profitability in the periods surrounding a recourse announcement.[24] They find that, relative to a matched sample of nonrecourse firms, recourse firms experience lower profitability, deteriorating performance, and lower stock returns in the year prior to the recourse announcement. They infer from this result that recourse events may be responses to poor performance. At the time a recourse action is announced, Higgins and Mason (2004) find, on average, a positive abnormal stock return, followed by improved share returns and operating performance. The authors also find that while the recourse firms face similar terms for subsequent securitizations relative to their prior securitizations, they also face delays before returning to the market. They conclude that "recourse may have beneficial effects for sponsors by revealing that the shocks that made recourse necessary are transitory" (Higgins and Mason 2004, 875).

Implications of this research. Several factors complicate the interpretation of research findings on the provision of implicit recourse. First, the recourse events documented occurred between 1991 and 2003, under three different accounting standards on financial asset transfers.[25] The research does not show clearly how each form of recourse documented was handled by the standard in effect at the time and whether every form of recourse documented would have violated then-existing requirements for sale accounting. Second, it is not clear whether these forms of recourse were indeed only implicit (that is, unstated) or whether the recourse provisions were explicitly stated in the securitization transaction. That is, research has identified recourse *events,* but the research does not always clearly show whether these outcomes reflect implicit recourse or contractually specified recourse. Third, the research investigates recourse events only in (revolving) credit card securitizations, and results may not generalize to other types of securitizations. Fourth, the research does not consider (close) substitutes for recourse, in particular, the transferor's holding of subordinated interests in the transferred assets. The difference turns on whether the transferor assumes credit risk by agreeing to be paid last (subordination) or by agreeing to make payments if necessary.

The research on recourse raises several issues. One way to interpret researchers' focus on recourse is that FASB (and, possibly, the IASB) has overlooked a set of arrangements that, if present, should invalidate sale accounting. In other words, has FASB misplaced its emphasis by requiring analysis of other forms of continuing involvement and relatively

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[24] Higgins and Mason's (2004) results should be interpreted cautiously, since the analysis is based on only ten firms.

[25] Statement No. 77 was effective through December 31, 1996; Statement No. 125 was effective from January 1, 1997, through March 31, 2001, and Statement No. 140 is currently in effect.

briefly discussing recourse? Alternatively, the research may illuminate implementation issues and not issues with the standards themselves. That is, given that Statement No. 140 requires that the fair value of recourse obligations accounted for as a sale be subtracted in calculating the proceeds in a transfer of financial assets, are researchers and regulators in fact expressing concerns about implementation?

A second issue, and one that extends beyond the financial reporting for asset transfers, is whether *implicit* (as opposed to contractual or explicit) recourse meets the accounting definition of a liability. More broadly, this issue concerns the treatment of implicit (that is, unstated) arrangements, in particular, implicit promises to perform that might be inferred from an entity's actions and relied upon by others. FASB has grappled with this issue in several contexts, as it has attempted to determine what types of arrangements give rise to noncontractual obligations that should nonetheless be recorded as liabilities.[26] However, it is not clear whether an unstated promise to provide an unspecified amount of recourse in a transfer of financial assets would qualify as a liability even under a generous interpretation of the current definition, and even taking an expansive view of constructive obligations.[27]

Investor Treatment of Financial Asset Transfers

The evidence on how investors view financial asset transfers is sparse and largely indirect, consisting of statements about how analysts, credit rating agencies, and regulatory bodies treat securitizations, and empirical analyses of both systematic risk and valuation effects of securitization gains/losses. With regard to statements about how analysts evaluate securitizations, Niu and Richardson (2006) report that analysts generally treat securitizations as secured borrowings because they believe that most or all of the risks of the transferred assets remain with the transferor. Landsman et al. (2006) examine equity valuations of the assets and liabilities of SPEs and find that the market views those assets and liabilities as belonging to the sponsoring originator. Consistent with this view, Moody's Investors Service (2003, 4) states, ''To date, we have observed very few examples of meaningful risk transference through securitization.'' When a securitization fails to transfer meaningful risk, Moody's (2003, 7) views ''the securitization as the equivalent of on-balance sheet secured financing.''

Regulatory bodies also indicate in their statements that they sometimes view securitizations as being similar to secured borrowings, with respect to risk transfer. Again, the focus seems to be on providing implicit recourse as a form of continuing involvement that (should) preclude sale treatment. For example, the Office of the Comptroller of the Currency (2002) *Guidance 2002-20* states that originators who provide implicit recourse must re-recognize assets for determining regulatory capital requirements. The Federal Reserve System Board of Governors' (2002, 1) Supervisory Letter states that providing implicit recourse ''demonstrates that the securitizing institution is reassuming risk associated with the securitized asset that the institution initially transferred to the marketplace,'' and ''providing

[26] See, for example, paragraphs B18–B22 of Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, and paragraphs B21-B31 of Statement No. 143, *Accounting for Asset Retirement Obligations*. In both cases, FASB compares the arrangement at issue with the definition and characteristics of a liability, including a *present* obligation that the entity has *little or no discretion to avoid*.

[27] The issue appears to be one of *economic compulsion*, in which an entity's actions are determined by economic self-interest, not contractual obligations. In this case, the transferor would take actions because of reputation effects: a transferor that intended to securitize assets in the future might feel economically compelled to provide recourse.

implicit recourse can pose a high degree of risk to a banking organization's financial condition and to the integrity of its regulatory and public financial reports."

Niu and Richardson (2006) empirically analyze both systematic risk and valuations of securitization gains/losses. With regard to the former, they find that off-balance sheet debt related to securitizations and on-balance sheet debt have the same relation to beta; that is, securitizations are treated like secured borrowings in the determination of systematic risk. (The authors do not examine whether investors appear to treat the transferred assets as if they were in fact still under the control of the transferor.) With regard to the latter, they find that gains from securitizations are less value-relevant than other earnings components, and that those gains are less valued for firms with higher levels of off-balance sheet debt. The authors conclude that investors are increasingly skeptical about the value-relevance of the securitization gains as the amount of off-balance sheet debt increases.[28]

The research on investor treatment of financial asset transfers, while sparse and sometimes indirect, could suggest that investors tend to view most transfers as secured borrowings—that is, the transferor still has the assets (even though transferred) and has encumbered those assets with a loan. The standard-setting implication of this interpretation, taken to its extreme, is that investors believe the transferor (1) has retained the risk/reward of the assets and presumably controls those assets and (2) has an obligation equal to the loan. This extreme implication might, however, be affected by other considerations.

First, the existing research tends to focus on evidence that the transferor has retained the credit risk of the transferred receivables by, for example, retaining a subordinated interest. Research has not focused on whether investors view the transferred assets as continuing under the transferor's control; the legal isolation requirement of Statement No. 140 would imply that the transferor does not have access to the cash flows of those assets.

Second, and related to the first point, inspection of contractual arrangements governing financial asset transfers indicates that the transferor has, typically, sold *something*, even if not the entire bundle of risks and rewards that comprise the asset. Specifically, even if the transferor has retained a significant subordinated interest in the transferred assets, it no longer has control of the cash flows of those assets (they are paid first to the investors in the transferred assets). In addition, a transferor that retains a subordinated interest in order to absorb most or all of the credit risk of the transferred assets does not have a liability. Rather, it has a potentially low-value asset. Finally, even a transfer of receivables with full recourse does not constitute a present obligation of the transferor to repay the entire loan—the investors must look first to the transferred assets.

Transferor Responses to Changes in the Accounting Rules Related to Financial Asset Transfers

As previously discussed, research suggests that accounting rules affect the structure of financial asset transfers. In addition, anecdotal evidence suggests that transferors expend resources to structure securitization transactions to meet the accounting requirements for sale treatment, for example, to ensure that the legal entity used in a securitization transaction is a qualifying SPE. It is not clear, however, whether firms expend resources to structure transactions primarily to meet the requirements for sale accounting, or for economic reasons.

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[28] These results do not indicate whether investors view securitization gains as being similar to other gains and losses, either in terms of their transitory nature or in terms of measurement reliability. That is, the results do not shed light on whether the market valuation of securitization gains and losses is similar to the valuation of other gains and losses on, for example, sales of available-for-sale securities or sales of fixed assets.

Some insight can be obtained on this issue by investigating responses to changes in standards that affect the accounting for financial asset transfers. For example, Bens and Monahan (2005) report a decline in the level of sponsorship of asset-backed commercial paper conduits by U.S. banks following the release of Interpretation No. 46R, *Consolidation of Variable Interest Entities*.[29] They also report that some U.S. banks created new (higher cost) securities called ''expected loss notes'' (ELN) to avoid consolidation of conduits. (The holder of the ELN is the primary beneficiary of the variable interest entity and, therefore, consolidates the conduit.) They conclude that, in response to the issuance of Interpretation No. 46R, companies changed the structures of commercial paper conduits in order to obtain a desired accounting outcome.

Bens and Monahan (2005) also conclude that the consolidation rules of Interpretation No. 46R put U.S. banks at a disadvantage relative to U.S. nonbanks and foreign banks. That is, U.S. banks appeared to lose market share to entities that are not subject to the same accounting rules and to the same form of regulation that is tied to ratios based on reported financial statements. If this conclusion is valid, then it highlights the importance of convergence between the IASB and FASB on a single standard for asset derecognition so that differing accounting standards do not affect competitiveness.

The standard-setting implications of research that documents firms' responses to changes in accounting standards are not clear. Guided by its conceptual framework, FASB aims to promulgate standards that are *neutral* in the sense of unbiased and not intended to influence the behavior of a particular group. FASB acknowledges that knowledge of financial reporting outcomes affects behavior, just as other measurements do; if a change in financial reporting standards results in providing more decision-useful information, then any subsequent changes in behavior will be based on better financial information.[30]

DISCUSSION AND SUGGESTIONS FOR FUTURE RESEARCH

Summary and Limitations of Research Findings

Research suggests that transfers of financial assets are economically significant in terms of the amounts involved and effects on leverage ratios, and that transferors include retailing, manufacturing, and real estate firms as well as financial institutions. Research also suggests that financial asset transfers occur for a variety of reasons, including diversifying assets, obtaining greater liquidity for growth, and reducing financing costs. Finally, researchers have suggested the possibility of manipulated fair value measurements in connection with calculating gain or loss on financial asset transfers accounted for as sales, although factors associated with stricter corporate governance appear to mitigate this effect.

Sale accounting for transferred financial assets is not consistent with significant continued involvement with those assets. Although many forms of continued involvement exist, research has tended to focus on providing implicit recourse and transferor motivations for doing so. Finally, research suggests that both credit analysts and investors appear to treat off-balance sheet financing related to financial asset transfers as if it were on-balance sheet debt in assessing firm risk, and that firms alter their securitization activities in response to changes in accounting requirements.

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[29] Interpretation No. 46R, using a risk-and-rewards approach to consolidation analysis, requires certain sponsors of highly leveraged asset-backed commercial paper conduits to either redesign or consolidate the conduits (that qualify as variable interest entities).

[30] Examples of FASB's discussions of this issue include paragraphs B29–B31 of Statement No. 123R, *Share-Based Payments*, and paragraphs 130-132 of Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*.

Several characteristics of the research limit the implications of these findings. First, much of the research discussed is unpublished; therefore, the results and inferences might change as the papers are modified in response to the peer review process. Furthermore, most issues discussed have been addressed by only one or two studies, some of which rely on small sample sizes and/or limited time periods, without controls for differences in accounting rules across periods. In addition, some of the studies examine credit card securitizations, some examine loan securitizations, and some examine a combination of different types of securitizations. Future research could examine whether the type of securitization or the specific features of the securitization are important factors in the analyses.

Examples of Open Issues that Could be Addressed by Research

While research provides insights into certain issues related to financial asset transfers, many questions remain unanswered. For example, while some researchers appear to draw the inference that some, most, or even all financial asset transfers should not be accounted for as sales, research has not addressed whether investors might be misled if all financial asset transfers were accounted for as secured borrowings. That is, research could examine whether investors would be misled if transferors' balance sheets showed assets that have been legally isolated from the transferor (so that the transferor cannot access its cash flows) and a liability for the entire obligation (even though the transferor has no present obligation to pay that amount). This research might provide evidence on what might be superior criteria (relative to those in Statement No. 140) for distinguishing between financial asset sales and secured borrowings. Research might also consider the advantages and disadvantages of the all-or-nothing sale versus secured-borrowing approach in Statement No. 140 relative to the Joint Working Group proposal to account for the transferors' assets (e.g., retained interests, call options) and liabilities (e.g., recourse obligations) after the transferor.

While research has examined whether investor assessments of systematic risk (beta) appear to treat securitizations as if they were secured borrowings, further investigations could provide additional insight into other investor judgments and decisions. For example, research could examine whether investors' estimates of firm value are affected by variations in the structures of financial asset transfers.

Research could also provide direct evidence of how equity and credit analyst judgments and decisions are affected by differing accounting treatments of financial asset transfers. Some research finds that analysts are not sophisticated in adjusting financial statements for off-balance sheet items (for example, Hirst et al. [2004] find that commercial bank equity analysts are able to analyze banks' exposure to interest rate risk under recognition but not disclosure of fair values), but the evidence discussed here suggests analysts make an explicit adjustment for off-balance sheet debt.

Finally, in analyses of continuing involvement, academic research has focused on the provision of implicit recourse in determining whether transferred financial assets should be derecognized. However, other types of continuing involvement in transferred assets might raise equally (or more) serious questions about whether the assets should be derecognized.

Impediments to Academic Research on Financial Asset Transfers

We believe that the lack of data is the most important impediment to archival-empirical research on financial asset transfers. This impediment takes at least three forms.

First, Statement No. 140 has been in effect in the United States only since 2001; outside the United States IAS No. 39 (as amended) has been effective only since 2005. Thus, as noted earlier, there is a dearth of time-series outcomes under the accounting guidance that is currently in effect, and there is no way to know whether research results and inferences based on outcomes reported under previous accounting guidance remain relevant.

Second, and equally important, it appears to be difficult to obtain (typically, to hand-collect) data on financial asset transfers, and, sometimes, even to identify the arrangements. For example, Niu and Richardson (2006) report that after attempts to identify "as many as possible" U.S. firms that both undertook securitizations during 1997–2003 and were listed on both CRSP and Compustat, they obtained 103 firms (535 firm-year observations) but only 41 firms with complete data.[31] Dechow et al. (2005) report that an EDGAR search of Form 10-K filings of all firms filing with the SEC during September 2000 to December 2002 yielded 80 firms (127 firm-year observations) with the data required for their analyses.

Third, to the extent that the contractual provisions of financial asset transfers determine both the economic characteristics and the accounting treatment, the data impediments are even more formidable. While Form 10-K, containing the disclosures required by Statement No. 140, is a searchable public document, the contractual provisions might be found only in very difficult-to-access sources, for example, in the offering materials provided to investors.

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[31] Niu and Richardson (2006) do not report the details of their sample identification/selection procedures.

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