

{Thought in Action} *faculty research*



## Accounting for Toxic Assets

Cathy Shakespeare Seeks Balance Between Regulation, Innovation

**V**aluing asset securitizations always has been a difficult issue for the accounting profession. Now, with the recent collapse of the credit and financial markets, a new layer of complexity further complicates the equation.

Professor **Cathy Shakespeare** has studied some of the shortcomings in existing regulations that apply to asset securitization, as well as the abuses and confusion that resulted from these shortcomings. She thinks a few changes are in order, such as revamping income statements, requiring more disclosures, and using linked presentations of assets and liabilities to more accurately reflect net positions. One thing that is not on her agenda: suspending the mark-to-market

standard, as some banks have advocated.

Shakespeare isn't pleased with one of the recent changes by the Financial Accounting Standards Board (FASB) that she says weakens the mark-to-market standard. The FASB sets accounting rules in the U.S. Instead, she advocates a robust regulatory environment that restores credibility to a shaken market but doesn't squash financial innovation.

"It's very difficult to regulate for the 'what if,'" says Shakespeare, the PricewaterhouseCoopers-Norm Auerbach Assistant Professor of Accounting at Ross. "All we can do is pay attention to the lessons we've learned. You have to remember that accounting is more of a social science in that we set the rules. It's not like physics where we find out what the rules are. When you write a rule you have to be aware, or

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try to be aware, of the unintended social consequences. You won't always figure out every one, but you do have to try to minimize the unintended consequences. And it's been a year full of them."

**HOW WE GOT HERE** Securitization used to be a term rarely heard outside the circles of finance or accounting. Today it's worked its way into mainstream conversation, daily headlines, and nightly newscasts. The structured financial process involves the pooling and repackaging of cash flow-producing assets into securities that are then sold to investors. So when banks want to securitize assets like mortgages or car loans, they bundle them together and transfer them to a trust known as a special purpose entity (SPE). The SPE, now

current economic meltdown. Books are now cluttered with "toxic" assets — tough to quantify, even tougher to offload.

**MAKING THE RULES AS YOU GO** Even in healthy markets, these structured instruments were challenging for accountants to deal with because they lie somewhere between a sale and a collateralized borrowing. It's not like selling an object or hard asset, where a company receives cash and doesn't own the item anymore.

"Asset de-recognition, which is kind of the broad group into which asset securitizations fall, is something we don't really know how to deal with," says Shakespeare. "We just don't have a conceptual model. It's not something we know the answer to yet."



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purely a cash flow machine, issues securities that can be bought and sold.

For their part, buyers take security in the knowledge that the value of the package doesn't just rest on the creditworthiness of one borrower, but on the collective creditworthiness of a group of borrowers. Mortgages can be re-bundled and securitized multiple times, and often the loan originator will take back some of the retained interest or make an implicit guarantee to retain some of the risk.

When a securitization pool performs as expected, values are relatively easy to mark. But in recent years, securities backed by too many ill-conceived mortgages and other types of weak cash flows were packaged and repackaged, bought and sold at a dizzying pace. After two or three layers of securitization, identifying the credit risk of the original mortgagee is extremely difficult. And few investors looked hard at the underlying quality of mortgages and other assets in a given package or at what management assumptions were made on default rates.

Those same investors took a huge hit when the bottom fell out of the housing market. Dramatic credit deterioration led to losses and write-downs in value, a situation that sparked the

The FASB has given accountants some direction on this murky path. In 1997, it issued Standard 125, which said that companies could treat a securitization as a sale, given certain conditions. This created gain-on-sale accounting. That meant the assets could come off the books, a company wouldn't have to recognize a liability, and it could record a gain given certain conditions.

But, Shakespeare notes, under that rule the gains could be manipulated and there were few disclosures. So in 2000, the FASB tweaked existing regulations by creating Standard 140, which added significant disclosures.

Then the FASB added more rigors that went into effect in 2007 with Standard 157, which lays out a three-level, hierarchical order for determining the fair value of assets and liabilities. Level one is simply the price one can get in the open market. Level two establishes value by piecing together observable inputs such as interest rates, default rates, cash flows, and contract terms to establish value. Level three allows the managers of a company to use internal estimates about what kind of price an asset would fetch in the market.

Standard 157 led to mark-to-market accounting in which banks value securities according to market prices. The

problem is that, right now, there is no market. As a result, regulators have made it easier for companies to use the level-three disclosures. And though investors don't like level-three disclosures because of the wider use of estimates, it's a legitimate accounting tool, especially in a nearly frozen credit market, Shakespeare says. But many banks have called for the suspension of mark-to-market accounting

One of three new decisions issued by the FASB recently has Shakespeare concerned. The FASB didn't suspend mark-to-market accounting, Shakespeare says, but it did relax the standard some. An investor group decried the measure, but it was hailed by the banking trade group.

The new interpretation allows companies and banks to use more judgment to value assets for what they would fetch in an orderly sale instead of a distressed sale. When losses are recorded, it allows the company to record only the credit loss on the earnings statement. The rest of the market value decline can be marked in the "other comprehensive income" category.

The FASB did add some disclosures that will help investors determine how the bank arrived at its values, but Shakespeare thinks the new guidance does an end-run around bank regulatory rules. That's because the new guidance affects the earnings statement, which helps set a bank's capital requirements.

"By changing the accounting rules they are, in effect, changing the regulatory capital rules so the banks don't look as distressed as they actually are," Shakespeare says. "What we should be doing is fixing the bank regulations."

**RESEARCH RAISES RED FLAGS** Shakespeare's research has illuminated some areas of concern even before the recent change. She studied whether investors were able to use disclosures to distinguish if a securitization should be considered more of a sale or a collateralized borrowing. She found they really can't.

Her other area of study focused on how corporate managers treat securitizations. She found the majority of transactions occur in the last five days of a quarter because most securitizations qualify for the gain-on-sale treatment.

Often the valuations were at the favorable end of a range and had the effect of improving quarterly earnings.

"It's very hard for the auditors to disagree with them as long as the assumptions are within a reasonable range," Shakespeare says. "So we have looked at whether the gains are manipulated and, yes, they are. They are managed to smooth earnings."

More recently, Shakespeare has looked at the gains on securitizations and how they relate to executive compensation. A reported gain is not necessarily recognized as cash on the date of securitization, and the research suggests some CEO pay might have been inflated.

**PUTTING THE TOOTHPASTE BACK IN THE TUBE** The big problem now is that banks are reporting huge write-downs because they're unable to sell these securities in the market without taking a significant loss. Any bank that originated, sold, or holds mortgage-backed securities is vulnerable to big write-downs in their value, weakening their regulatory capital.

But Shakespeare advocates more fundamental changes than the recent FASB decision provides, ones that would give investors better information and still be fair to companies originating and holding these securities. The measures would face political hurdles, but she thinks they represent a better solution to a difficult problem.

First, she thinks income statements in quarterly and annual reports should be changed to reflect true cash earnings and the reported gains and losses from financial instruments.

"It's a little simplistic to think we can summarize the whole of a company's operations into one number," she says.

Regulators are now considering changes to FASB Standard 140, which allows companies to take these instruments off their balance sheets if they qualify for gain-on-sale accounting. One thing regulators should consider is what she calls a "linked presentation." That would bring these assets onto the balance sheet but link them with the corresponding liabilities so that what shows at the bottom is the net effect instead of the gross positions that produce some of these staggering numbers.

"Normally, we keep assets and liabilities gross and separate," Shakespeare says. "If you put them together, you would just see the net positions; the disclosures would allow you to figure out what the gross positions are."

It's still unclear what form further regulations will take. But no one can argue against the need for continued research and analysis to address some of these issues that now bedevil accountants.

"I see my work, hopefully, providing some guidance to the regulators about how we need improved transparency," Shakespeare says. "I think it educates people about the weaknesses in financial statements. I teach my MBAs how to understand securitizations, how they're reported in financial statements, what they say and don't say, and what they should be looking for." ✦ —*Terry Kosdrosky*



► Professor Cathy Shakespeare teaches MBAs to understand securitizations and how they're reported in financial statements.