Financial Reporting Differences Under SFAS 125

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Abstract

SFAS 125 was fully effective after December 31, 1997. The main issues covered by the standard are transfers and servicing of financial assets and recognition of liabilities. This article focuses on the differential financial statement effects and ratio impact of recording transfers as sales versus as secured borrowings. An example illustrates the income and ratio manipulation possibilities afforded by the standard.

Introduction

In June 1996, the Financial Accounting Standards Board (FASB) released Statement of Financial Accounting Standards No. 125 (SFAS 125). It is titled *Accounting for Transfers and Servicing of Financial Assets and Servicing of Liabilities*, and was fully effective after December 31, 1997.

As its title indicates, the standard encompasses three main areas. First, it covers the accounting at the time of transfer for transfers of a variety of financial assets. Second, it stipulates the accounting for the servicing of financial assets both at and subsequent to transfer. Third, SFAS 125 directs that liabilities can be derecognized only if the debtor pays them or is otherwise legally released.

The bulk of SFAS 125 deals with transfers of financial assets in which the transferor has a continuing involvement with the assets. The key issue is whether such transfers should be recorded as sales or as secured borrowings. To provide a defined focus, our interest in this article is limited to an examination of the differential

financial statement effects of these two alternatives for recording such transfers.

Many transactions are "close calls" that could go one way or the other, yet the verdict (sale or secured borrowing) can have a substantial impact on the financial statements, and on ratios that are derived from those statements. To the extent that information derived from financial statements is used by investors, creditors and others in making decisions, the accounting differences between the two alternatives are important.

Accounting for Transfers of Financial Assets Under SFAS 125

SFAS 125 defines a financial asset as "cash, evidence of ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from the first entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity." Examples of assets covered by the standard are loan syndications and participations, banker's acceptances, and transfers of receivables with recourse.

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When the transferor has no further involvement, a transfer of a financial asset is clearly accounted for as a sale. However, the proper accounting is not readily apparent when the transferor maintains some involvement after the transfer, such as recourse provisions or repurchase agreements. The issue is whether the transfer should be accounted for as sale or a secured borrowing.

SFAS 125 uses a *financial components approach* that focuses on control. If the transferor surrenders control, the transaction is a sale; otherwise, it is a secured borrowing. What does it mean to surrender control? This question is addressed in paragraph 9 of the standard, which maintains that control is surrendered if and only if all three of the following conditions are met. First, the transferred assets have been isolated from the transferor - put presumptively beyond the reach of the transferor and its creditors, even in a bankruptcy or other receivership. Second, either (1) each transferee obtains the right - free of conditions that constrain it from taking advantage of that right - to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right - free of conditions that constrain them from taking advantage of that right - to pledge or exchange those interests. Third, the transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable. If any of these conditions are not met, then the transfer is accounted for as a secured borrowing.

There are very diverse journal entries for sales versus secured borrowings. In the next section, an illustration is provided to depict the effects of these alternative accounting treatments on financial statement values and ratios.

Illustration of Differential Financial Statement Effects

To demonstrate the financial statement differences between accounting for a transfer as a sale or a secured borrowing, we present a simplified illustration of transferor accounting based on the transfer of a zero-coupon bond with a face value of \$100,000 that the transferor agrees to repurchase. Per Panel A of Table 1, the transfer occurs on December 31, 1998 when the bond has a carrying value of \$92,500 (approximate interest rate 8 percent), and the transferor obtains cash of \$90,100 in the exchange. The bond matures one year later on December 31, 1999.

Table 1
Assumptions For The Example

PANEL A: Assumptions at 12/31/1998

Maturity date	12/31/1999
Face value	\$100,000
Interest rate	8 percent
Carrying value	\$ 92,500
Cash received	\$ 90,100

Repurchase required 12/31/1999 => sale
Repurchase required 12/30/1999 => secured borrowing

PANEL B: 12/31/1998 Transfer Journal Entries

Sale:

Cash	\$ 90,100	
Loss on sale	2,400	
Bond investment		\$ 92,500

Secured borrowing:

Cash	\$ 90,100	
Payable		\$ 90,100
Bond loaned out	\$ 92,500	
Bond investment		\$ 92,500

SFAS 125 makes a distinction between repurchase before maturity and repurchase at maturity. If the repurchase is scheduled to occur before maturity, then the transferor is said to maintain control over the asset and the transfer is accounted for as a secured borrowing. If the repurchase will be at maturity, the transfer is accounted for as a sale.

In the example, we manipulated this factor by scheduling the repurchase both on the maturity date (sale) and one day prior to the maturity date (secured borrowing). In Panel B of Table 1, the journal entries at the time of transfer are shown for both alternatives. For sale treatment, the sale of an asset with a book value of \$92,500 for only \$90,100 results in a loss of \$2,400. The repurchase commitment is an executory contract in which neither party has performed, so no journal entry is recorded.

If the transfer is considered a secured borrowing, the cash receipt is accounted for as any other borrowing, resulting in a debit to cash and a credit to a short-term payable. The asset stays on the books of the transferor, but is reclassified to indicate the transfer as shown in the second entry. This reclassification has no financial statement effect.

In Table 2, we present the impact of the two alternatives on the income statement and balance sheet, and on important ratios that are derived from those financial statements. The numbers in the *Before Transfer* column were arbitrarily assigned by the authors.

If the transfer is accounted for as a sale, the loss of \$2,400 reduces income and equity. The debit to cash of \$90,100 and the credit to bond investment for \$92,500 (shown in Table 1) combine to decrease current assets by \$2,400. If the transfer is accounted for as a secured borrowing, there is no income statement effect. The debit to cash and credit to payable (shown in Table 1) increase both current assets and current liabilities by \$90,100.

Of greater interest than the differential effects on financial statement values themselves are the effects on ratios derived from those values. We selected four popular ratios that are used extensively by investment analysts and creditors - two derived from earnings [earnings per share (EPS) and price-earnings (P/E)] and two from balance sheet values [debt to equity and current ratio].

As observed in Table 2, accounting for the transfer as a sale dramatically reduces EPS, thus increasing the price-earnings ratio. There is a slight increase in debt relative to assets and equity, which is reflected in the debt-to-equity ratio and the current ratio. Conversely, secured borrowing treatment has no effect on EPS or the price-earnings ratio, but increases debt relative to assets and equity by a greater margin, as reflected in the two balance sheet ratios.

The impact on the transferee is not as significant. A sale for the transferor becomes a purchase for the transferee, an increase in one current asset (the investment) and a decrease in another (cash). A secured borrowing for the transferor is a lending transaction for the transferee. Again, this means an increase in one current asset (receivable) and an equal decrease in another (cash).

Returning to transferor considerations, what *qualitative* consequences might stem from the differential *quantitative* effects on the ratios? This question is explored in the next section.

Potential Qualitative Impact of Differential Quantitative Effects

The ratios that we selected for inclusion in Table 2 are popular benchmarks used by both investors and creditors in deciding whether to invest in or lend money to a particular company. Investors and potential investors will be more interested in earnings per share and the price-earnings ratio, whereas creditors and potential creditors will look more closely at the current and debt-to-equity ratios.

Table 2
Comparative Financial Statements and Ratios

Comparative Income Statements for 1998

	<u>Before Transfer</u>	<u>Sale</u>	<u>Secured Borrowing</u>
Operating net income	\$ 5,000	\$ 5,000	\$ 5,000
Loss on sale	<u>-0-</u>	<u>(2,400)</u>	<u>-0-</u>
Net income	<u>\$ 5,000</u>	<u>\$ 2,600</u>	<u>\$ 5,000</u>

Comparative Balance Sheets at December 31, 1998

	<u>Before Transfer</u>	<u>Sale</u>	<u>Secured Borrowing</u>
Current assets	\$400,000	\$ 397,600	\$490,100
Long-term assets	<u>600,000</u>	<u>600,000</u>	<u>600,000</u>
Total assets	<u>\$1,000,000</u>	<u>\$997,600</u>	<u>\$1,090,100</u>
Current liabilities	\$190,000	\$190,000	\$280,100
Noncurrent liabilities	<u>300,000</u>	<u>300,000</u>	<u>300,000</u>
Total liabilities	490,000	490,000	580,100
Stockholders' Equity	<u>510,000</u>	<u>507,600</u>	<u>510,000</u>
Total equities	<u>\$1,000,000</u>	<u>\$997,600</u>	<u>\$1,090,000</u>

Comparative EPS and Key Ratios - 1998

	<u>Before Transfer</u>	<u>Sale</u>	<u>Secured Borrowing</u>
EPS (@4,000 shares)	\$1.25	\$0.65	\$1.25
Debt to Equity	0.96	0.97	1.14
Current Ratio	2.11	2.09	1.75
P-E Ratio (@ price of \$12.50)	10	19	10

Earnings per share is probably the most widely quoted accounting statistic. The market eagerly awaits the quarterly and annual results of major companies, and stock prices react to those results. Companies are interested in accomplishing two objectives regarding EPS - keep it moving steadily upward and beat the analysts' forecasts.

In our example, suppose EPS had been

rising steadily at 10 percent a year: \$0.91 in 1995, \$1.00 in 1999, \$1.10 in 2000. Continued growth at that rate would necessitate EPS of at least \$1.21 for 1998. The manner in which the December 31, 1998 transfer is structured will be the deciding factor in whether or not the 1998 target is met. If the repurchase is scheduled for December 31, 1999, then the transfer is accounted for as a sale. This results in EPS of only \$0.65. However, what if the timetable is arranged such that the transferor will buy back the securities one day earlier, on December 30, 1999? Then the transfer is considered a secured borrowing and EPS of \$1.25 is reported, thus exceeding the target. Growth investors, who key their investment choices to companies' with consistently rising earnings, may thus decide to invest in the company if it reports EPS of \$1.25,

and not invest if the company only reports EPS of \$0.65.

Another ratio of importance to investors is the price-earnings ratio. Value investors look for stocks that are undervalued to invest in. One measure commonly used to assess whether a stock is undervalued is the price-earnings ratio. A low (of course this is a relative term) P/E ratio is a signal to buy the stock. If the transfer is ac-

counted for as a sale, the P/E ratio is 19. However, if it is considered a secured borrowing, then the P/E ratio is only 10, and the stock is likely to be more attractive to value investors.

Therefore, EPS is higher, and the P/E ratio is lower, if the transfer is a secured borrowing rather than a sale. The bottom line: reporting the transaction as a secured borrowing would probably make the stock of the company more attractive to *both* growth and value investors. Of course, the opposite would be true if sale treatment resulted in a recorded gain.

As noted previously, creditors are more likely to be concerned with the two balance sheet ratios, debt-to-equity and the current ratio. The current ratio is one of the primary measures of short-term solvency, the ability to pay debts as they come due. Quite simply, the current ratio assesses the ability to meet current obligations from current assets. The zero-coupon bond is a current asset, because it matures in one-year.

We organized the example so that before the transfer, the current ratio is above the benchmark value of 2 to 1. What if the company is applying for a revolving line of credit? The bank may have a requirement a current ratio of at least 2 to 1. If the transfer of the bond is deemed to be a secured borrowing, current assets and current liabilities both increase by \$90,100, but the *ratio* falls to \$1.75, below the critical value. However, if the repurchase is moved back just one day, the transfer is treated as a sale. Although the current ratio does go down, the decrease is slight. More importantly, the ratio stays above 2 to 1. This could make the difference in whether the company obtains the line of credit. At the very least, it could impact the interest rate that the bank will charge.

The fourth ratio presented in Table 2 is the debt-to-equity ratio, although in popular usage the term "ratio" is normally dropped. In the example, we set up the "before transfer" balance sheet so that debt-to-equity would be below 1 to 1.

In most cases, a company with more debt than equity would be considered highly leveraged. Consider that a debt covenant on an outstanding loan could require that the company maintain this ratio at less than 1 to 1. If the transfer is accounted for as a secured borrowing, the resulting journal entries do not have any impact on stockholders' equity. However, the payable increases liabilities, which in turn increases debt-to-equity to \$1.14, resulting in a violation of the debt covenant.

Again, moving the scheduled repurchase back one day provides the solution. This would lead to the transfer being recorded as a sale. Debt-to-equity does increase, yet stays below the 1 to 1 level. Thus, the company would be able to avoid violating the debt covenant.

Some Considerations

We should note that there are several opportunities to report different financial statement values for essentially similar circumstances under SFAS 125 beyond the issue of a change in the repurchase date. For instance, consider a transfer of receivables recorded as a sale, in which the transferor maintains a recourse obligation for delinquent accounts. The recourse obligation is measured at fair value, so that changes in the assessed "fair value" will directly impact the gain or loss on the sale. Numerous such situations are contained in SFAS 125, but to focus the article, we elected to concentrate on the most prominent issue of sales versus secured borrowings.

In the example addressing this issue, we were able to demonstrate that pivotal differences in key ratios could result by changing the repurchase date by one day. In real terms, though, the company is in the same position with either date. If the repurchase is at maturity, there will typically be a cash settlement. If the repurchase occurs the day before maturity, the transferor obtains the actual securities, then obtains the cash the very next day. The cash difference at the end of 1999 will be negligible, but the reported dif-

ference at the end of 1998 is substantial.

Although the example was designed to have the greatest possible impact on the ratios of interest, it was intended to show that there could be real-world consequences from differences in accounting for these "close calls." Finally, it should be stressed that the *magnitude* of the differences in ratios is often less important than whether the differences are on either side of some key benchmarks or past performance figures.

Suggestions for Future Research

We have demonstrated the possible financial statement consequences associated with SFAS 125. Further, we demonstrated that the standard allows terms to be structured to reach desirable financial statement outcomes.

Future research should be directed at ascertaining the actual effects of the standard. We would encourage others to collect and analyze relevant empirical data regarding the financial statement impact. A comparison of financial asset transfers accounted for as sales to financial asset transfers accounted for as secured borrowings would be especially helpful.

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