# Linked Presentation

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## Bringing Securitisation back onto the Balance Sheet

*The accounting treatment for asset securitisation has been a much debated topic in recent years. The reason for the controversy stems, amongst other things, from the complexity of these transactions, and the fact that the economic substance of the transactions may not be readily apparent, as securitisation transactions are often structured very carefully to ensure that they remain "off-balance sheet".*

The objective of this article is threefold. First, to briefly describe the typical structure of securitisation transactions. Second, to consider the alternative accounting treatments and more specifically the treatment recently proposed by the Accounting Standards Board (ASB) in the United Kingdom – "Linked Presentation". Finally, to assess the likely impact that the linked presentation proposals will have on the treatment and reporting of securitisation transactions.

## The Structure of Securitisations

The securitisation of assets is a fairly new development in Southern Africa and an option that has mainly been used in the banking sector. In the United States of America, however, securitisation has become a main source of off-balance sheet financing. Lee[1] reported in 1989 that $800 billion worth of mortgage-backed issues had been launched in the USA.

Securitisation can be seen as an arrangement through which finance is obtained to fund a specific block of assets, rather than funding the business as a whole. The process of securitisation can be divided into five sections:

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|---|---|---|
| ORIGINATION | - | Section 1 |
| STRUCTURING | - | Section 2 |
| CREDIT ENHANCEMENT | - | Section 3 |
| PLACEMENT | - | Section 4 |
| SERVICING | - | Section 5 |

Securitisation originates when a bank or large company (the **originator**) identifies a block of homogeneous income producing assets such as mortgage loans, accounts receivable, credit card balances and leases, as being suitable for use as security to obtain outside finance. The originator will usually structure the securitisation so that the assets are sold to a special purpose vehicle (SPV). The special purpose vehicle may be a trust, a group of underwriters or a receivables investment company. The shares or interest in the SPV is usually not held by the originator to ensure that the issuer is not classified as a subsidiary of the originator. The securitisation can therefore be omitted from the consolidated financial statements of the originator.

The originator makes the securitisation more attractive to potential investors by arranging some form of credit enhancement such as over collateralisation, third party insurance, subordinated debt, third party guarantees and standby letters. The SPV obtains the cash to reimburse the originator by issuing asset backed securities such as debentures or commercial paper to **investors** and the SPV is then called the **issuer**. The nature of the securitised assets is usually such that ongoing administration is required and a **servicer** is therefore appointed. The originator often acts as the servicer of the assets and although the securitised assets may disappear from the statutory financial statements of the originator, they may well remain in the internally generated management accounts to facilitate their servicing.

The originator may, after distributions to investors, have access to the surplus income of the SPV through service or other fees; deferred sale considerations; super interest on amounts owed to the originator; dividend payments, and swap payments.[2] The issuer may, in certain circumstances, reserve the right to buy back the securities from investors. Such repurchases can be funded indirectly by the originator.

## Alternative Accounting Treatments

The debate on the accounting treatment of securitisations centres around the question: "What is the economic substance of securitisation – is it a sale or is it a financing arrangement? The answer to this question has far-reaching implications for the originator's financial reporting after the securitisation process has been completed.[3] It is argued that if all significant risks and benefits are transferred from the originator to the issuer that the economic reality of the transaction is that of a sale. The securitised assets will then be removed from the balance sheet, in other words, will be derecognised, no liability in





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respect of the securities issue will be reflected and the cash receipt from the issuer will be recorded in the records of the organisation together with a profit or loss on the sale of the assets, where applicable. If significant risks and benefits remain with the originator, the economic reality of the transaction can be viewed as being a financing arrangement. The securitised assets, the cash receipt and the liability for the issued securities will appear on the balance sheet of the originator.

As the potential for "off-balance sheet" financing forms an important part of the benefits derived from securitisation, the process is, in practice, often planned carefully to appear as a sale. The possible recourse that the issuer may have against the originator can be central to the determination of the nature of the transaction. The rules or guidelines are generally written so that the more (less) recourse against the originator increases (decreases) the more likely the transaction will be viewed as a secured loan.[4] The abuse of rules and guidelines are facilitated further by the fuzzy reference in accounting standards to ill defined terms such as all "significant" risks and benefits, or "substantially" all risks and benefits.

The Accounting Standards Board addressed the accounting problem of economic substance in FRS 5 by identifying three types of transactions:

(i) The first type is the transaction where all significant benefits and all significant risks of the asset are transferred and the transaction is recognised as a sale.
(ii) The second type is where the transaction does not transfer significant benefits or significant risks relating to the asset and the asset remains on the balance sheet.
(iii) The third type caters for transactions that fall in between the previous two instances, where not all significant benefits and risks have been transferred.[5]

A special form of presentation termed "linked presentation", is used for transactions that fall into the third category. This type of presentation discloses, on the asset side of the balance sheet, the gross amount of the securitised assets less the amount of liabilities secured by these assets. The use of the linked presentation format is appropriate where:

- the finance is secured by a specific asset or group of assets;
- the investors have no recourse either explicit or implicit for losses;
- the originator has no right or obligation to re-acquire the securitised assets;
- the originator has retained some of the significant benefits and risks in the securitised assets.

The main purpose of the linked presentation form is to bring "off-balance sheet" assets and liabilities from securitisation transactions, amongst others, back into the financial statements.

## The Impact of " Linked Presentation" on Securitisations

As mentioned, some of the benefits of securitisation originates from the fact that these transactions are treated as sales. One of the most important benefits in the banking section is that it provides savings on capital. If a loan is no longer in the accounts, then it does not have to meet the Regulator's minimum capital requirements against the assets.[6] Ratios such as return on assets, return on equity and the gearing ratio will appear more favourable. Credit ratings may improve when a bank or company extends its flexibility by tapping into new off-balance sheet sources of finance, without affecting their existing sources of finance.

The originators of existing securitisations that have been structured to be recorded as sales, may find that the assets and liabilities that disappeared from their balance sheets may now be reinstated through the linked presentation form if the requirements of FRS 5 are followed. The impact of linked presentation may, however, only be felt on existing securitisations. It is envisaged that legal advisers to future securitisations will merely go back to the drawing board to ensure that their transactions are not caught in the linked presentation net.

The impact of linked presentation in South Africa is likely to be limited to some of the larger multinational corporations. Smaller companies may, however, have to take cognisance of the ASB's requirements in order to fairly present, as there is no definitive South African statement or guideline on securitisation. Some guidelines on the legal structuring of securitisation transactions have, however, been issued by the Reserve Bank. Our standard setters may, nonetheless, consider this new form of presentation as a feasible alternative in their ongoing quest to eliminate off-balance sheet financing in South Africa.

**References:**

1) P Lee "Trillions of Assets to Package" September 1989 *Euromoney* pp 69-70.
2) The Certified Accountants Education Trust *Accountants Guide* 7 ed 1994 p 531.
3) Eugene A Imhoff Jr "Asset Securitisation: Economic Effects and Accounting Issues"' March 1992 *Accounting Horizons* pp 5-16.
4) Op cit.
5) Accounting Standards Board *Financial Reporting Standard 5 Reporting the Substance of Transactions* April 1994.
6) J M Ocampo "The ABC of Asset Securitisation" *The Bankers Magazine* Vol 172 pp 22-24.
7) Sandra Thompson "Bringing substance to transactions" May 1994 *Accountancy* p 96.

## Conclusion

*The concept of linked presentation is innovative and its main aim is admirable. It is, however, debatable whether this form of disclosure will succeed in bringing securitisations back on the balance sheet. It will probably result in a proliferation of innovatively designed securitisation schemes that will, through clever legal arrangements hide the true nature of the transaction and, once again, succeed in escaping the net. However, the ASB has anticipated such practices and has emphasised its determination to see the spirit of FRS 5 applied, and to stamp out abuses. FRS 5 has been framed in general principles rather than detailed rules, precisely so that it can be applied to new schemes as they develop. Nevertheless, if new schemes are developed to circumvent the FRS, the ASB has stated its intention to refer them to the Urgent Issues Task Force or if necessary, to revise the FRS itself[7]. It seems the battle against off-balance sheet financing practices will continue in the foreseeable future.* ❐



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