ASU 2016-15 and GAAP Treatment of Securitization-Related Cash Flows

Catching up to the Fast-Moving Financial Sector

By Cecil W. Jackson and David M. Jackson

The securitization of trade receivables is a multibillion-dollar sector, and it is growing. It is vitally important that U.S. GAAP correctly reflect the economics of these transactions. This article argues that, in essence, cash inflows resulting from a transferor's beneficial interest in the securitization of its trade receivables are inflows from operating activities. Importantly, and for very good reason, investors generally regard cash inflows from operating activities more highly than cash inflows from investing activities.

Securitization of Accounts Receivable

Accounting Standards Update (ASU) 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments,* included a change in the reporting of cash receipts from the securitization of financial assets and the securitization of accounts receivable. The standard states, "Cash receipts from payments on a transferor's beneficial interest in securitized trade receivables should be classified as cash inflows from investing activities."

Typically, when a company securitizes its receivables, it transfers the receivables into a special purpose vehicle (SPV), which issues notes to investors backed by the cash flows generated by such receivables. The initial payment amount to the transferor often requires the transferor to "have some skin in the game," in the sense that it receives further payment depending upon the extent to which the receivables are collected. In other words, in addition to receiving the initial payment upon the transfer of the receivables, it also receives a "beneficial interest" (or what is sometimes characterized as a "deferred purchase price") in the collection of the receivables, to the extent that such collection exceeds specified payment amounts to third-party investors in the securitized receivables. This beneficial interest could be in the form of the transferor of the receivables holding a residual equity interest in the SPV, or in the form of holding the most subordinate tranche of the securitized receivables. Either way, the transferor receives an initial payment plus a beneficial interest or a right to receive possible future payments.

Operating Activities or Investing Activities?

There is no issue as to where the initial payment amount to the transferor of the receivables should be disclosed in the transferor's statement of cash flows; clearly, that amount must go into the cash flow from operating activities (CFFO) section, as ASU 2016-15 states. ASC Topic 230, "Statement of Cash Flows," defines CFFO as cash received from activities that "include delivering or producing goods for sale and providing services."

Of course, cash receipts from trade receivables do arise from these activities. ASU 2016-15 requires, however, that the cash receipts from payments, in respect of the transferor's beneficial interest in the securitized receivables, must be disclosed as cash flows from investing activities (CFFI). The authors dispute this requirement: CFFI typically consists of cash flows from selling or buying long-term assets, or selling or buying investments (securities) in other entities that are not specifically acquired for resale. The cash received from a beneficial interest in securitized trade receivables is not analogous to either of these typical CFFI activities.

In the case of typical investments in other companies, the cash being used has already been received by the entity, and the receipt of that cash has already been recorded as a CFFO, a CFFI, or a cash flow from financing activities. As that cash is later spent on an investment in another company, it is then correctly recorded as a cash outflow on an investing activity. When the investment in another company is sold, the cash receipt is properly recorded as a cash inflow from an investing activity. This is very different from the receipt of the proceeds from the beneficial interests in securitized receivables, which arose from "delivering or producing goods for sale and providing services," which had not yet been recorded as any kind of cash flow.

When the beneficial interest right arose, it would have been correctly recorded at that time as a noncash entry. It is only recorded as a cash activity when the proceeds of the beneficial interest are later received by the transferor. This is not cash received from the sale of an investment in another company. Hence, the cash receipt from a beneficial interest in securitized receivables is not analogous to cash received upon the sale of an investment in another company. It is the receipt of the most subordinate portion of the trade receivables, which originated as a result of an operating activity.

Disputing the EITF's Arguments

ASU 2016-15 states that some Emerging Issues Task Force (EITF) members had noted the lack of symmetry in not recording the receipt as a cash inflow from an operating activity. The analogy with the receipt from the sale of a typical investment breaks down even further, however, on the grounds that the cash used for the typical investment in another company would first have been recorded as a cash inflow, and the cash spent on the investment would then have been recorded as a CFFI cash outflow, and then finally, the cash received from the sale of the investment in another company would be recorded as a CFFI cash inflow.

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The truth of the matter is that ASU 2016-15's treatment of cash received from a beneficial interest is not analogous to how cash flows are treated with typical investments. For example, assume that a bakery bakes bread, sells it at a profit, uses the cash received to buy an investment in another company, and then sells that investment. The entity would record a CFFO inflow from selling the bread at a profit, a CFFI outflow for the purchase of the investment, and then a CFFI inflow from the selling of that investment. The point is that the CFFO from the selling of the bread comes first. Under the treatment required by ASU 2016-15, the transferor is never able to record the cash received from the beneficial interest in its trade receivables as a CFFO. This is not analogous to the required GAAP treatment for generating cash via an operating activity, spending it on an investment in another company, and then selling that investment. The essence of the economic transactions involved in generating the trade receivables and securitizing them for cash inflows is not captured by the new guidance.

The other typical category of CFFI activities consists of cash flows from selling or buying long- term assets; these assets are capital assets that are factors of production. Generally, cash received from the sale of these assets necessitates the spending of that cash on replacing the sold factors of production, or it causes the entity to borrow cash to replace them. Returning to the bakery analogy, CFFI is cash received from selling an oven; the oven needs to be replaced, or the business must be scaled down or liquidated. CFFO, on the other hand, is cash received from baking bread, selling it at a profit to customers, and receiving the cash from those sales. CFFO is, therefore, more attractive to investors than CFFI; any manager can sell the bakery's oven and get cash, but getting cash from selling bread at a profit is achieving the financial objective of the company, and it is not as easy to do.

Clearly, the cash receipt from a beneficial interest in securitized receivables is not analogous to cash received upon the sale of a bakery's oven. Thus, the cash received from a beneficial interest in securitized receivables is not akin to either of the typical forms of CFFI. It is not analogous to a cash inflow from the sale of an investment in another entity, and it is not analogous to a cash inflow from the sale of a bakery's oven. It literally is cash received as a result of "delivering or producing goods for sale and providing services," which is ASC 230's definition of operating activities. As such, it should be classified as CFFO.

ASU 2016-15 also noted that some EITF members were in favor of the CFFI classification on the grounds that the transferor's ability to receive cash from its beneficial interest is "sometimes linked to the performance of third-party trade receivables." It is indeed true that in some securitization cases, trade receivables are transferred into an SPV, together with the receivables of another entity. The authors agree that the portion of the beneficial interest that flows from another entity's receivables should be classified as CFFI; however, this is not an argument that all the cash received from the beneficial interest should be classified as CFFI. If it is not practical to separately identify the receipts from each source of receivables, the authors submit that the update should follow its own advice, given in the "Issue 8" section of ASU-2016-15. The cash inflow should be classified in terms of what is "likely to be the predominant source." If the major source of cash inflows from the beneficial interest is likely to be the transferor's own receivables, the cash inflow should be classified as CFFO.

Example Based on Update 2016-15 Requirements

Assume that a bakery (Sourdough Co.) has $50 million of accounts receivable and a reserve for doubtful debts of $5 million. Assume that Sourdough Co. securitizes $45 million of accounts receivable with a face value of $50 million, receives an initial payment of $40 million, and acquires a beneficial interest (or deferred purchase price) valued at $5 million. Assume also that Sourdough Co. later receives a cash flow of $5 million in respect of its beneficial interest.

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The treatment under ASU 2016-15 is shown in the below journal entries:

At time of securitization (Entry 1):

Dr. Cash $40,000,000 (CFFO)
Dr. Beneficial Interest or Deferred Purchase Payment Asset $5,000,000
Cr. Accounts Receivable $45,000,000

In a period after initial securitization, when cash payment is received with respect to the beneficial interest in securities (Entry 2):

Dr. Cash $5,000,000 (CFFI)
Cr. Beneficial Interest or Deferred Purchase Payment Asset $5,000,000

The authors agree with ASU 2016-15's treatment as described in Entry 1 above; however, they argue that the "Debit Cash $5 million" in Entry 2 should be disclosed as CFFO. This is cash received as a result of baking bread and selling bread; it is *not* akin to cash received from selling the entity's oven. It is also not akin to money received from selling investment securities that an entity acquired in other entities, since those securities were obtained by paying cash that had already been received and accounted for as a cash flow item. For this cash receipt, it is the first time that the cash is being accounted for, and it results from an *operating* activity. In addition, it is an interest in the transferor's own receivables. It is not an interest in another entity's assets.

The Right Classification Is Important

On the basis of the above analysis, GAAP clearly should not treat the cash receipts from a transferor's beneficial interest in securitized trade receivables as cash receipts from the sale of a typical investment security for the purpose of the statement of cash flows. The cash receipts are inflows from the transferor's own trade receivables, which are being collected in an increasingly common way in the current financial environment. They should be disclosed as cash flows from operating activities. As explained above, cash inflows from operating activities are generally regarded more highly than cash inflows from investing activities. The multibillion-dollar securitization of the trade receivables sector is just a part of the trillion-dollar global asset-securitization industry, and as such it is important that GAAP does not adversely characterize the economics of these financial transactions.❑

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