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THE CLASSIFICATION OF CASH FLOWS FROM COLLECTIONS OF RETAINED INTERESTS RELATED TO SECURITIZATIONS OF CUSTOMER-RELATED RECEIVABLES

EXECUTIVE SUMMARY

When receivables are securitized, the sponsoring company typically continues to hold an interest, referred to as a retained interest, in the underlying pool of receivables. Retained interests may be considered to be securities that the firm classifies as being held for trading, available-for-sale, or held-to-maturity purposes.

Depending on whether or not they are considered to be securities and how those securities are classified, cash flows arising when retained interests are collected may be reported as components of either investing or operating activities. Collections of retained interests arising from securitizations of customer-related receivables are in-substance operating cash flow and are best considered as such for purposes of analysis.

In this study, we examine reporting practices for retained interests arising when customer-related receivables are securitized. We propose adjustments to operating cash flow when proceeds received from retained interests are reported as investing cash flow.

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Georgia Tech Financial Analysis Lab

The Georgia Tech Financial Analysis Lab conducts unbiased stock market research. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times our research may look at stock prices generally, though from a fundamental and not technical point of view.

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Companies Named In This Report

> *"The fact is that we live in a world of accelerating technological change, financial innovation, and globalization with rapidly shifting competitive dynamics and regulatory action. … In such a dynamic world, standard setters cannot possibly anticipate – and predetermine accounting rules for – every transactional innovation." (From the report of the Staff of the U.S. Securities and Exchange Commission, June 15, 2005)*

Introduction

There is a significant degree of reporting flexibility in the classification of cash flows arising from retained interests due to securitizations of receivables. As a result, the consistency of cash flow reporting and its usefulness in analysis are affected. Differing practices in the classification of retained interests have been found to improve the apparent financial performance of some companies while hurting the performance of others. Such variability clouds financial analysis, especially affecting models involving operating cash flow and free cash flow. In this study we examine the reporting practices for retained interests and suggest a way to approach this problem and evaluate its impact on operating cash flows.

The securitization of receivables has developed rapidly during recent years as a more economical way to raise funds and enhance a firm's liquidity. Technological and financial innovation make it feasible for companies to isolate and market specifically engineered combinations of rights to various streams of cash flows. Securitizations have become more sophisticated and flexible in adjusting both to client needs and to the regulatory environment. However, as noted by the staff of the SEC "…the very complexity and flexibility inherent in new tools and practices renders the goal of transparency substantially more difficult to achieve."[1]

The focus of this report is on the impact that complexity and flexibility in the reporting of securitization transactions exerts on cash flow and the resulting implications for financial analysis. In particular, our aim is to identify possible distortions to a company's financial performance that can occur due to variability in the classification of cash flows from collections of retained interests arising from securitizations of customer-related receivables.

The Target: Sustainable Operating Cash Flow

It is hard to overestimate the importance of operating cash flow and the closely-related metric, free cash-flow, to a firm's overall financial health. These are viewed as sustainable sources of cash and serve as the drivers behind firm value.

For a more accurate assessment of a firm's cash-generating ability, however, various adjustments to reported operating cash flow are needed in order to highlight sustainable sources of cash. Depending on their classification, we think that adjustments for cash flows from retained interests due to securitization transactions may be needed.

[1] Securities and Exchange Commission, *Report and Recommendations Pursuant to Section 401 (c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers,* June 15, 2005.

Retained Interests: A Closer Look

A securitization of receivables is meant to serve two key objectives. First, it is designed to boost a firm's liquidity and shorten its cash cycle by liquidating receivables earlier than would be possible otherwise. Second, it lowers a company's cost of capital by providing a lower risk financing alternative to lenders and investors.

In a securitization transaction, ownership of high-quality receivables is transferred to a bankruptcy-remote, special purpose entity. Undivided interests in the pool of receivables, often in the form of commercial paper, are then sold to investors. In order to better secure the interests sold against the pool of receivables, the sponsoring company may retain a subordinated interest in them (i.e. a retained interest) as a way of offering additional collateral. By retaining an interest in the pool of receivables in this manner, investors are offered what is often referred to as an "over-collaterization."

When a company transfers an undivided pool of selected customer receivables to a securitization entity, it receives only partial cash consideration, thus providing a discount of sorts on the receivables sold. By receiving $80 of proceeds from transferring $100 worth of receivables while retaining the right to the remaining $20, for example, the company creates a safety cushion. This cushion serves two primary purposes. First, it is intended to absorb unexpected credit losses that may result in the course of collecting the receivables. Second, it is used to cover interest paid by the special purpose securitization entity on the certificated beneficial interests (such as commercial paper, but also senior notes and trust certificates) issued to investors in the pool of receivables.

By providing support in the form of retained interests, the company continues to be involved with the securitized assets. It should be stressed that, unlike the senior interests issued to the investors, the residual interests that a company retains in the pool of the securitized receivables are subordinated (although occasionally they may include small amounts of senior securities). This means that they provide the right to receive residual cash flows from collections on the sold receivables after the principal and interest due is paid to investors. These subordinated interests are the first to absorb credit losses on the receivables sold. Thus, by retaining interests, the company essentially retains credit risk in the securitization and protects the holders of the senior asset-backed securities.

Depending on the structure of the particular transaction and the extent of continuing involvement that the company wishes to maintain, it may hold different combinations of retained interests. Such interests include undivided interests in receivables, residual interests, interest-only strips[2], and servicing interests[3].

[2] Interest-only strips usually include some or all of the difference between the interest collectible on the receivables being serviced and the rate paid to the owners of beneficial interests – the investors.

[3] Typically, the company continues to service the pool of securitized receivables. For these services the company receives contractually specified fees. The fees may be approximately equal or exceed the costs that the company incurs when servicing the assets.

Continuing Involvement in Securitized Receivables

Not every securitization transaction involves retained interests. Consider,

> "In certain securitizations, a corporation … transfers financial assets to a special purpose trust in exchange for cash. The trust raises that cash by issuing to investors beneficial interests that pass through all cash received from the financial assets, and the transferor has no further involvement with the trust or the transferred assets."[4]

The securitizations that fall within the scope of our attention are those where a continuing involvement does take place. Consider,

> "In other securitizations, a similar corporation transfers financial assets to an SPE (special purpose entity) in exchange for cash and beneficial interests in the transferred assets. That entity raises the cash by issuing to investors commercial paper that gives them a senior interest in cash received from the financial assets. The beneficial interests retained by the transferring corporation represent a junior interest to be reduced by any credit losses on the financial assets in trust." [5]

Economic Substance: What Is Retained?

So, instead of full cash consideration for the receivables transferred to the securitization entity, the company receives one part of the consideration in the form of cash proceeds and the other part in interests that the company retains in the securitized receivables. According to SFAS # 140:

> "Other interests in transferred assets – those that are not part of the proceeds of the transfer – are retained interests over which the transferor has not relinquished control."[6]

In accordance with the "financial components approach" adopted by SFAS # 140, a company continues to record as an asset any portion of the transferred assets that it continues to control after the transfer and removes from its balance sheet the portion that it no longer controls. Since the interests are retained and the control over that respective part of the asset is not relinquished, the company continues to own a subordinated claim on the securitized receivables. Nonetheless, the transfer of the pool of receivables to the special purpose entity is considered to be a sale. Consider,

> "A transfer of financial assets (all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange."[7]

Consequently, to the extent that the consideration in the form of retained interests was received, the company continues owning the securitized receivables. In other words, the company keeps a

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[4] FASB, SFAS # 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, para. 80.

[5] Ibid., para. 81.

[6] Ibid., para. 58.

[7] FASB, SFAS # 140, Para. 9.

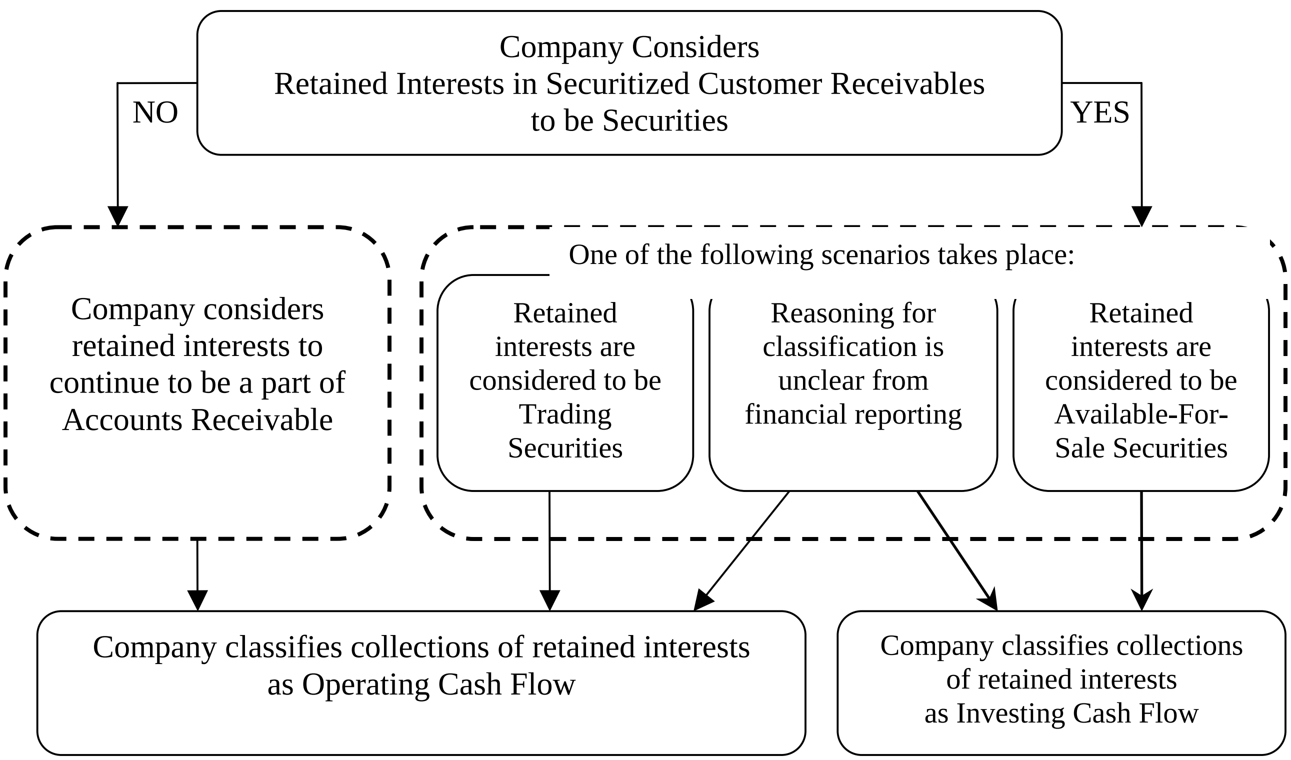
portion of the pool of securitized receivables that was not sold. As such, retained interests essentially represent accounts receivable that have not been collected, but rather changed in form in the process of securitization.

By selling one part of securitized receivables and retaining interests in the other, a company changes from owning the entire asset to owning the unsold part of it. Because the retained interests still represent a claim on company receivables, we think that the ultimate collection of that claim should be reported as operating cash flow. However, in practice, the actual classification and timing of that cash flow varies.

Cash Flow Classification in Practice

Whereas there is little uncertainty about the cash flow classification of cash proceeds from securitizations of customer receivables (as cash flows from trade receivables they are reported in operating cash flow), the other facet of the transaction - reporting of collections of retained interests in the securitized receivables - triggers more ambiguity and receives different reporting treatment by companies.

The following flowchart should be helpful in better understanding how companies classify cash flows arising from collections of retained interests.



Companies that consider retained interests to be securities employ the following accounting guidance:

> "Interest-only strips, retained interests in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, except for instruments that are within the scope of Statement 133, shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended (paragraph 362[8])." FASB, SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, Para. 14.

Thus, retained interests may be likened to either available-for-sale or trading securities. In fact, we found that some companies refer to SFAS No. 115 in their annual reports when classifying their retained interests as securities of either kind. As shown in the flowchart, depending on the chosen classification, cash flows from retained interests may end up in either the operating or investing section of the cash flow statement. Consider the following:

> "Cash flows from purchases, sales, and maturities of available-for-sale securities and held-to-maturity securities shall be classified as cash flows from investing activities and reported gross for each security classification in the statement of cash flows. Cash flows from purchases, sales, and maturities of trading securities shall be classified as cash flows from operating activities."[9]

A large group of companies did not refer to SFAS No. 115 in their classification of retained interests and did not recognize their retained interests as securities. FASB accepts this position as well:

> "The majority of the companies that had disclosures related to Statement No. 140 were companies in various industries that sold "trade receivables." Although these companies disclosed information regarding the "transfer of financial assets," the companies seem to take the position that they are not subject to the required disclosures in Statement No. 140. This appears to be technically correct because no "securities" (as defined in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities) are created in their trade receivable "sales/securitization" transactions, which are typically commercial paper conduit transactions."[10]

These companies classified cash flows arising from collections of retained interests as operating cash flow.

Thus, depending on the classification of retained interests in securitized receivables, we see their collections being classified at times as operating cash flow and at others as investing cash flow.

[8] "A security may not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment." FASB, SFAS # 140, para. 362.

[9] FASB, SFAS # 115, para. 18.

[10] FASB, *Study "Statement 140 - A Study of Securitization Disclosures"*, para. "Companies with Trade Receivables Sales Programs"

A Suggested Approach For the Cash Flow Classification of Retained Interests

As seen here, the classification of cash flows arising from retained interests is an issue that is both subjective and discretionary. The FASB does provide us with clear guidance for the classification of cash flows arising from securitizations. This guidance is based on the original source of the cash. The FASB notes that securitization cash flows should be classified as operating activities in order to be consistent with FASB requirements:

> "Most nonfinancial companies classified the costs and cash flows associated with the sales/securitization program as operating income (expense) and operating activities, respectively. However, a number of companies, apparently incorrectly, classified their securitization gains (losses) as interest income (expense) or failed to classify the securitization cash flows in a manner consistent with the requirements of FASB Statements No. 95, Statement of Cash Flows, and No. 102, Statement of Cash Flows — Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale, or did both. For example, paragraph 22(a) of Statement 95 specifically requires that proceeds arising from trade receivables transfers be classified as operating cash flows."[11]

Although it can be argued that retained interests may not constitute proceeds from securitizations, they are still "cash flows associated with the sales/securitization program" – more specifically - the part of consideration that was received in the form of beneficial interests. In addition, the origination of retained interests related to the securitization of customer-related receivables is from a sale – an operating activity. As such, we think that cash flows arising from collection of retained interests related to such securitizations are most appropriately classified as operating activities. Moreover, by maintaining an operating cash flow designation for all retained interests of customer-related receivables, there would be no opportunity to accelerate the reporting of operating cash flow.

The Study: Scope and Focus

The scope of our study included retained interests from securitizations of customer-related receivables, such as trade receivables, franchise receivables, financing receivables for customer-related sales, and floor-plan receivables. We identified non-financial firms who disclosed the existence of beneficial interests, residual interests, undivided interests, subordinated interests, or other retained interests in securitized customer-related receivables in their Form 10-K filings with the SEC.

We examined the consolidated statement of cash flows and the notes to financial statements to determine the following:

a) whether the retained interests in question pertained to securitizations of receivables that were customer-related and, accordingly, the result of sales or services,
b) whether collections of the identified retained interests were classified in the operating or investing sections of the statement of cash flows,
c) the impact of the classification and timing of cash flows related to retained interests on each firm's operating cash flows.

[11] FASB Study "Statement 140 - A Study of Securitization Disclosures", Paragraph "Classification in Financial Statements".

Results

Our results are presented in a series of exhibits.

We big with Exhibit 1 where we present companies that report originations of retained interests as a non-cash investing and operating activity. Subsequent collections of retained interests are reported as investing cash flow, and, to the extent that collections of retained interests are considered in substance to be an operating activity, operating cash flows are understated. In the Exhibit we adjust operating cash flow upward to include collections of retained interests that are reported as investing cash flow.

Exhibit 2 presents a company that reports originations of retained interests as a non-cash investing and operating activity. Subsequent collections of retained interests are reported as operating cash flow, and accordingly, we do not think that an adjustment is needed.

Exhibit 3 provides a collection of companies that report both cash proceeds from securitizations of customer related receivables and changes in retained interests from those securitizations in the operating section of the statement of cash flows. Financial analysis of these companies is not complicated by the necessity to factor out distortions of operating performance indicated in Exhibit 2. For reference, in Exhibit 3 we provide information on the net cash effect of retained interests on operating cash flow.

Exhibit 1. Examples of Companies with Retained Interests in Securitized Receivables Classified as a Non-Cash Investing and Operating Activity. Subsequent Collections of Retained Interests are Reported as Investing Cash Flow. (In thousands of USD)

Company	Fiscal Year Ended	Reported Cash Provided (Used) by Operating Activities	Collections of Retained Interests Reported in Investing Cash Flow	Adjusted Cash Provided (Used) by Operating Activities	% Change in Operating Cash Flow
Bluegreen Corp.	12/31/2004	89,760	13,589	103,349	15.14%
	12/31/2003	28,680	12,817	41,497	44.69%
	12/31/2002	7,698	14,555	22,253	189.08%
Caterpillar Inc.	12/31/2004	(3,991,000)	5,722,000	1,731,000	143.37%
	12/31/2003	(5,611,000)	7,129,000	1,518,000	127.05%
	12/31/2002	(3,962,000)	5,917,000	1,955,000	149.34%

Exhibit 2. Company with Retained Interests in Securitized Receivables Classified as a Non-Cash Investing and Operating Activity. Subsequent Collections of Retained Interests are Reported as Operating Cash Flow. (In thousands of USD)

Company	Fiscal Year Ended	Reported Cash Provided (Used) by Operating Activities	Collections of Retained Interests Reported in Operating Cash Flow
Conn's, Inc.	1/31/2005	28,898	19,630
	1/31/2004	155,938	12,801
	1/31/2003	28,428	14,750

Source: Company filings with the SEC

Exhibits 1 and 2 present companies that report originations of retained interests as a non-cash investing and operating activity. Companies in Exhibit 1 report subsequent collections of retained interests as investing cash flow. To the extent that collections of retained interests are considered in substance to be an operating activity, operating cash flows are understated. In the exhibit we adjust operating cash flow upward to include collections of retained interests that are reported as investing cash flow. The company in Exhibit 2 reports subsequent collections of retained interests as operating cash flow, and accordingly, no adjustment is needed.

Notes to Exhibits 1 and 2:

Bluegreen Corp.

The company is a leading provider of leisure products, timeshares or vacation ownership interests (VOI) in particular, through resorts and residential communities businesses.

For improved liquidity, Bluegreen regularly securitizes its notes receivable originated in the sales of VOI. According to 2004 Form 10-K annual report (p. 69): “We consider our retained interests in notes receivable sold as available-for-sale investments and, accordingly, carry them at fair value in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. …. Our ability to sell and/or borrow against our notes receivable from VOI buyers is a critical factor in our continued liquidity.”

The company has reported cash flows from newly originated retained interests as non-cash activities that amounted to $25.5 million, $22.3 million, and $18.1 million in 2004, 2003, and 2002 respectively.

Caterpillar Inc.

A principal line of the company’s business includes designing, manufacturing, marketing and sales of construction, mining and forestry machinery.

Caterpillar's Machinery and Engines operations generate trade receivables from the sale of inventory to dealers and customers. Certain portions of these receivables are periodically securitized using a revolving securitization structure.

As noted in Caterpillar's 2004 Form 10-K annual report (p.A-12): "Placing receivables into a securitization trust changes their nature and the receipt of certificated retained interests is considered a non-cash transaction. We have noted this non-cash transaction on the Consolidated Statement of Cash Flow and quantified the receivables decrease resulting from this transaction and thus excluded from operating activities. This reflects that certificated retained interests, not cash, were received for these sales."

Caterpillar considers the certificated retained interests as held-to-maturity securities as defined by SFAS No. 115.[12] Since SFAS No. 115 requires that collection of held-to-maturity securities be classified as an investing activity, in 2004 Caterpillar reclassified the collection of the certificated retained interests from Collection of Finance Receivables to Collections of Retained Interests in Securitized Trade Receivables within the investing cash flow. As pointed out in the company' 10-K annual report (p.A-13): "This reflects that although inventory was sold, the nature of the receivable was changed to a security. The subsequent collection of that security is shown as an investing activity." These changes resulted in a significant reduction of the operating cash flow and a significant increase in investing cash flow.

The company has reported cash flows from newly originated retained interests as non-cash activities that amounted to \$6.8 billion, \$7.5 billion, and \$6.3 billion in 2004, 2003, and 2002 respectively.

Conn's Inc.

The company is a specialty retailer of home appliances and consumer electronics. It enters into securitization transactions to sell customer retail installment and revolving receivable accounts. In these transactions, the company retains interest-only strips and subordinated securities, all of which are retained interests in the securitized receivables.

Despite the fact that according to Conn's 2004 Form 10-K annual report (p.59): "Retained interests are carried at fair value on the Company's balance sheet as available-for-sale securities in accordance with SFAS No. 115...", Conn's Inc. includes collections of the retained interests in the operating and not the investing section of the cash flow statement.

The company reported collections of retained interests in operating cash flow. However, the amounts were not reported as a separate line item within the operation cash flow. Instead, they were reflected as "Cash interest received from interests in securitized assets" in supplemental disclosure of cash flow information along with cash proceeds from new securitizations.

[12] Caterpillar is the only company that was found to classify its retained interests as held-to-maturity securities. Although such classification seems to be aligned with the economic substance of the asset, according to Paragraph 362 of SFAS 140 (Appendix D: Amendments to Existing Pronouncements): "A security may not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment." For this reason companies typically do not classify retained interests as held-to-maturity securities.

The company has reported cash flows from newly originated retained interests as non-cash activities in "Supplemental disclosure of non-cash activity". The supplementary disclosure also includes reinvested collections of retained interests as follows (in thousands of USD):

	2002	2003	2004
Customer receivables exchanged for interests in securitized assets	31,803	41,123	58,342
Amounts reinvested in interests in securitized assets	(43,495)	(56,478)	(81,652)

Exhibit 3. Examples of Companies with Retained Interests in Securitized Customer-Related Receivables Classified as Operating Cash Flow. (In thousands of USD)

Company	Fiscal Year Ended	Reported Cash Provided (Used) by Operating Activities	Net Cash Effect of Retained Interests Included in Operating Cash Flow
Bon Ton Stores Inc.	1/29/2005	28,898	(8,647)
	1/31/2004	155,938	(33,411)
	2/1/2003	28,428	(11,185)
Carmax Inc.	2/28/2005	44,736	(1,975)
	2/29/2004	148,464	(10,972)
	2/28/2003	71,967	(14,333)
Circuit City Stores Inc.	2/28/2005	455,879	32,867
	2/29/2004	(125,513)	(186,537)
	2/28/2003	(163,109)	(92,888)
Neiman Marcus Group Inc.	7/31/2004	52,572	242,565
	8/2/2003	164,652	(33,963)
	8/3/2002	247,162	12,115
Nordstrom Inc.	1/29/2005	606,346	(149,970)
	1/29/2004	599,282	(141,264)
	1/29/2003	390,514	(67,561)
Stage Stores Inc.	1/29/2005	132,394	-
	1/31/2004	321,866	-
	1/31/2003	109,324	-

Source: Company filings with the SEC

Exhibit 3 presents companies that report both cash proceeds from securitizations of customer-related receivables and changes in retained interests from those securitizations in the operating section of the statement of cash flows. As a result, no adjustment to operating cash flow is deemed necessary.

Notes to Exhibit 3:

Neiman Marcus Group Inc. issued a 10-K/A amendment to its annual report for the fiscal year ended July 31, 2004 “to correct errors related to the classification of changes in the Company’s undivided interests in the NMG Credit Card Master Trust in its statements of cash flows”. From 10-K/A: “The Company has previously reflected the changes in its Retained Interests in the determination of cash flows from investing activities. The Company has determined that such presentation is not in accordance with generally accepted accounting principles and has corrected such error by restating its statements of cash flows to include the changes in its Retained Interests in the determination of cash flows from operating activities.”

Stage Stores Inc., like many other companies, did not provide separate disclosure of changes in retained interests. Cash flows from retained interests are reported in the combined line “(Increase) decrease in accounts receivable and retained interest in receivables sold” on the cash flow statement. Other companies following this approach include: Adesa Inc., AirGas Inc., Convergys Corp., Delphi Corp., HLI Operating Co., Nalco Co., Diebold Inc., Sunterra Corp., and CONSOL Energy Inc.

Conclusion

Depending on whether or not they are considered to be securities and whether those securities are considered to be held for trading, available-for-sale, or held-to-maturity purposes, retained interests originated when customer-related receivables are securitized can create cash flows that may be reported as components of either investing or operating activities. Collections of retained interests arising from securitizations of customer-related receivables are, in-substance, operating cash flow and are best reported as such.

In this study, we examine reporting practices for retained interests arising when receivables are securitized. We propose adjustments to operating cash flow when proceeds received from retained interests are reported as investing cash flow. We also suggest adjustments for those firms who report operating cash flow prematurely, before actual collections have taken place.