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How Rules-Based Standard-Setting Facilitated the 2008 Subprime Crisis: Lessons from the "Qualifying Special-Purpose Entity" Concept

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Introduction

Historical Antecedents

During the start of the 21st century, the Enron scandal of 2001 and the 2008 financial crisis represented the two biggest shocks to the U.S. economy. In the former situation, Enron frequently used supposedly independent Special Purpose Entities (SPE) to manipulate earnings. In one such maneuver, Enron (Powers, 2002; Thomas, 2002; Schwarncz, 2002) would transfer its own stock, in exchange for cash or notes, to unconsolidated SPEs. Concurrently, Enron would guarantee the value of the SPEs, which would then hedge an investment on Enron's balance sheet. Some SPEs would then use their Enron stock as a principal form of payment. As a result, subsequent, permanent impairments in the value of Enron's hedged assets contributed to the SPEs' ultimate insolvency and Enron's ultimate bankruptcy.

Like many previous financial scandals, during the post-scandal period, regulators blamed weaknesses on the U.S. accounting/auditing standards and practices that underlay Enron's financial statements. In the case of Enron, the shortcomings in accounting and auditing were so egregious that, in 2002, the U.S. Congress passed the Sarbanes Oxley Act (SOX).[1] This statute contains measures intended to prevent the repeat of Enron-style earnings manipulation. These measures include the establishment of the Public Company Accounting Oversight Board (PCAOB);[2] the requirement that Chief Executive Officers (CEOs) take responsibility for their firms' internal controls and "sign-off" on the adequacy of those controls;[3] and assured funding by listed companies for accounting regulators' operations.[4]

Additionally, both the U.S. Securities and Exchange Commission (SEC) (2003) and the Financial Accounting Standards Board (FASB) (2002) advocated that the U.S. move from "Rules-Based" to "Principles-Based" accounting. Under a strict Rules-Based model, companies must follow detailed accounting rules in preparing their financial reports. Auditors then attest to whether companies have correctly applied those standards. Compliance with the standards is presumed to result in reliable financial statements (Benston et al., 2006, 165–166).

By contrast, Principles-Based systems (Benston et al., 2006) consist of broad objectives/principles (e.g., relevance, reliability) which standard-setters use to set general guidance (in the form of standards) on specific areas of financial reporting. Auditors then use this guidance to opine on whether an entity's financial statements reflect the economic substance of its transactions.[5]

In the context of the Enron episode, defenders of U.S. Rules Based GAAP (e.g., Beresford, 2002) argued that, when applied conscientiously, the FASB's standards result in reliable financial statements. However, in the case of Enron,

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[1] H.R. 3763, 107th Cong., 2nd Sess. (2002) (enacted).
[2] H.R. 3763, 107th Cong., 2nd Sess. (2002) (enacted), Title I.
[3] H.R. 3763, 107th Cong., 2nd Sess. (2002) (enacted), (Sec. 302 and 404).
[4] H.R. 3763, 107th Cong., 2nd Sess. (2002) (enacted), (Sec. 109).
[5] The description of the Principles-Based system provided herein is based on Benston et al.'s (2006, 170) description of the SEC's (2003) objectives-based model, which generally corresponds with the FASB's perception of Principles-Based Standards. Braun et al. (2015, 46) state that Principles-Based and Rules-Based accounting systems are two ends of a theoretical spectrum and that all accounting systems, to some extent, incorporate elements of both. U.S. GAAP are generally considered to be Rules-Based, while IFRS are usually considered to be Principles-Based.

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unscrupulous managers and negligent auditors permitted Enron to violate the detailed rules of U.S. GAAP for SPEs.[6] By contrast, supporters of the International Accounting Standard Board's (IASB) Principles-Based (e.g., Tweedie, 2002; Volcker, 2002) International Financial Reporting Standards (IFRS) argued that, using U.S. Rules-Based GAAP, Enron's auditors had placed too much emphasis on attesting to Enron's literal compliance with detailed standards and too little focus on judging the economic substance of Enron's financial statements.[7,8]

Despite the apparent strength of the post-Enron reforms (e.g., SOX) and the movement toward Principles-Based accounting, in the subsequent years (approximately 2003–2008) leading up to the bursting of the 2008 U.S. subprime bubble, banks engaged in Enron-style transfers of subprime loans to (supposedly) independent SPEs. In some cases, auditors provided these institutions' financial statements with unqualified (i.e., "clean") audit opinions shortly before the institutions' demise (e.g., Sikka, 2009).

One of the principal vehicles for the consummation of these transactions was an accounting artifact known as the Qualifying Special Purpose Entity (QSPE). The FASB created the QSPE concept in Statement of Accounting Standard (SFAS) 125 (1996). This standard defined QSPEs as SPEs: which were independent of the originating entity; wholly governed based on their underlying legal documents; only held "passive investments;" and in which investors (i.e., beneficial interest holders) held undivided interests in the SPEs' portfolios of financial assets (see the Appendix for a simple concept of a QSPE).[9] Based on these parameters, the FASB (2000, para. 46) ruled that originating entities should not consolidate their QSPEs' financial statements.[10] Consequently, the FASB decided that an originating entity's transfer of a financial asset to a QSPE should be treated as a third-party sale. Accordingly, the originating entity should derecognize the asset from its balance sheet and record a gain or loss on the transaction.

Despite the supposed independent, passive nature of QSPEs, post-bubble Congressional testimony (e.g., Bair, 2009; Smith, 2008) noted that some financial institutions had remained involved in QSPEs through loan guarantees, liquidity support, or other arrangements. Thus, similar to Enron, declines in subprime loan values initiated cyclical declines in QSPE values and banks' capital.[11,12] Ultimately, the subprime bubble, together with Congressional and investor pressure, forced the FASB to acknowledge the QSPE concept's weaknesses and remove it from U.S. GAAP.

Similar to post-Enron commentaries, regarding QSPEs, two post-bubble views emerged regarding the role of U.S. Rules-Based accounting/auditing in facilitating the subprime crisis. On one side, supporters of the FASB's Rules-Based GAAP (e.g., Herz, 2008) argued that, despite warnings by the FASB, financial institutions had contributed to the financial crisis by "stretching" their QSPEs beyond the concept's original intent (i.e., that QSPEs be independent and hold only passive assets which needed no active management). However, reflecting earlier concerns by the SEC (2003), critics argued that, starting with the QSPE's (1996) inception, the FASB had dedicated too much time and effort on developing detailed rules regarding the QSPE concept (Taub, 2009) and had neglected to consider whether the fundamental QSPE concept, itself,

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[6] Senate hearings before the Committee on Banking, Housing and Urban Affairs on Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: International Accounting Standards and Necessary Reforms to Improve Financial Reporting. 107th Cong., 2nd Sess. 2002. (Statement of Mr. Beresford). The words "may have" are used here because Mr. Beresford's testimony occurred before the full investigation of Enron had been completed.

[7] Senate hearings before the Committee on Banking, Housing and Urban Affairs on Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: International Accounting Standards and Necessary Reforms to Improve Financial Reporting. 107th Cong., 2nd Sess. 2002. (Statement of Mr. Tweedie).

[8] Senate hearings before the Committee on Banking, Housing and Urban Affairs on Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: International Accounting Standards and Necessary Reforms to Improve Financial Reporting. 107th Cong., 2nd Sess. 2002. (Statement of Mr. Volcker).

[9] The term "originating entity" herein refers to a financial institution that has created an SPE.

[10] In SFAS 140, the FASB (2000) defines passive investments as those which do not require active management, except for servicing. Examples include money market instruments, some fixed-income instruments, and non-voting shares of stock.

[11] Congressional Hearings before the Financial Services Committee of the U.S. House of Representatives on Regulatory Perspectives on Financial Regulatory Reform Proposals, 111th Cong., Sess. 1 (July 24, 2009) (Statement of Ms. Bair).

[12] Senate hearings before the Committee on Banking, Housing, and Urban Affairs, Subcommittee on Securities, Insurance, and Investment, on Transparency in Accounting: Proposed Changes to Accounting for Off-Balance Sheet Entities, 110th Cong. 2nd Sess (2008). (Statement of Mr. Smith).

was valid (Schacht and White, 2008).[13] Given these oversights, these critics (e.g., Schacht and White, 2008) stated that the FASB should have converged its securitization standards with (Principles-Based) IFRS, which prohibited the use of QSPEs.

Given the post-Enron calls for the U.S. to move towards Principles-Based Accounting, both the U.S. SEC (2003) and the FASB (2002) proposed models for adopting Principles-Based Standards in the U.S. As initially conceived, the complete transition to IFRS was to be accomplished by the early 2010s (Jones, 2012). However, in 2014–2015 the SEC leadership rejected a full convergence of U.S. GAAP with IFRS, stating that neither system had worked well in the financial crisis (Cohn, 2015). Subsequent progress has been made on converging U.S. GAAP with IFRS in specific areas of accounting; however, to date, the U.S. continues to employ a Rules-Based system.

Given this strong U.S. favoritism toward Rules-Based accounting, using the QSPE concept, this article examines the shortcomings of a Rules-Based standard-setting system during the pre-crisis building of asset bubbles. Consideration is also given to whether the use of forensic accounting techniques in a strong Rules-Based system could mitigate these shortcomings.[14]

Research Questions and Method

The role of Rules-Based loan accounting in the pre-crisis expansion of asset bubbles is considered in terms of both accounting regulation (i.e., standard-setting) and compliance (i.e., auditing). Regarding standard-setting, the principal question concerns the timeliness of standards during periods of financial crisis. The question is:

- In the years (2003–2008) during which the subprime bubble formed, did political and commercial interests' lobbying of the FASB regarding the details of the QSPE concept unnecessarily delay consideration of whether the concept itself was valid as well as whether the concept should be eliminated?

Using a well-known economic framework of the relation between financial deregulation and asset bubbles (Mishkin, 2008; McCarty et al., 2013; Calomiris and Haber, 2014), this question is explored by chronicling: the content of the three FASB promulgations, published in 1996–2003 (SFAS 125, SFAS 140, and Financial Interpretation (FIN) 46R)), which established and governed the use of QSPEs; the content of three FASB Exposure Drafts (ED), intended to reform the QSPE concept, published in the years (2003-2008) leading up to the bursting of the subprime bubble; and the comment letters on the three EDs.

Regarding accounting compliance, the question concerns whether, during the years in which the subprime bubble formed, the traditional periodic Rules-Based accounting system granted auditors sufficient professional latitude to independently judge the reasonableness of banks' loan transfers of securities to QSPEs. This question is:

- Did auditors base unqualified audit opinions on financial institutions' literal compliance with the detailed rules regarding QSPEs, or their professional judgment regarding the economic substance of banks' transfers of financial assets to QSPEs?

The cases of Bear Stearns and Citigroup are examined to assess whether auditors used the QSPE concept to provide the institutions with unqualified audit opinions shortly before the institutions' (effective) insolvencies.

Contribution to Literature/Practice

The use of a well-known economic framework to contextualize the rise and fall of the QSPE concept enables the highlighting of three issues regarding how Rules-Based standard-setting impacted the subprime bubble. These issues include:

Issue 1: Initial documentation of how Interests Resisted Reforms to an Accounting Rule during the Building of a Specific Asset Bubble.

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[13] The SEC makes these observations regarding Rules-based accounting in its 2003 report required by the Sarbanes Oxley Act. The same criticisms regarding the impact of rules on independent auditor judgment were also manifested in the subsequent case of QSPEs.
[14] No comparison is made between Rules-Based and Principles-Based accounting since these concepts have been widely debated. Also, as noted above, the U.S. has effectively opted for a Rules-Based system.

Economists and finance academics have long studied the regulation of financial crises, including aspects of bank accounting/auditing, from a long-term, comparative, and historical view. This research is manifested in seminal comparative research studies on the history of crises (e.g., Reinhardt and Rogoff, 2011; Herrera et al., 2020); models on the role of banking information and auditing in financial crises;[15] research centers (e.g., Yale's Program on Financial Stability) and their published cases (e.g., Wiggins et al., 2019); and, comprehensive historical treatises on specific crises (e.g., McCarty et al., 2013; Calomiris and Haber, 2014). By contrast, accounting research has focused on how technical issues and trends, such as Off-Balance Sheet accounting (Kothari and Lester, 2011) and loan loss provisioning (Laeven and Majnoni, 2003; Beatty and Liao, 2011; Bushman and Williams, 2012) interrelate with bank stock prices and credit cycles. As a result of this technical view, relative to economic and financial scholarship, accounting research has produced fewer long-term "lessons learned" on how institutional and system-wide (economic, legal, and regulatory) forces impact the effect of poor bank loan accounting on the expansion of asset bubbles. Arguably, this short-term, technical view may hinder the accounting profession's influence in the passage of legislation that affects economic/financial systemic risk.[16] This study begins filling this void by considering how, during prolonged times of rapid financial innovation and deregulation, constituent resistance to reforming or eliminating a detailed, weak bank loan accounting standard (such as the QSPE concept) may provide banks with the time and opportunity to utilize the standard to overstate loans (i.e., contribute to the building of asset bubbles).

Issue 2: More Systemic View of Auditor Independence.

In addition to a longer-term view of financial crisis, some accounting academics call for a deeper understanding of the U.S. accounting system's role in causing scandal and crises. For example, Merino et al. (2011) criticize the Enron reforms, most notably SOX, as constituting simple changes to the U.S.'s shareholder-centric reporting system rather than representing a fundamental transition to a system which considers a broader set of stakeholders. An example might be the traditional view of audit independence, which emphasizes that close auditor/client contacts constitute the strongest obstacle to audit independence. While this view is generally accepted and correct, system-level factors may also hinder auditors' ability to assess financial statement reliability freely. For example, researchers have recognized that industries engage in political and FASB-level lobbying for passage of favorable accounting rules (to which auditors must attest). By extension, in its post-Enron, prebubble report on Principles-Based accounting, the SEC (2003) argues that strong requirements for auditors to attest to clients' compliance with detailed rules minimizes auditors' ability to independently judge financial statement reliability. In the years leading up to the subprime bubble, greater awareness of such system-level obstacles to audit independence may have helped regulators and banks avoid repeating accounting errors (e.g., overuse of Off-Balance Sheet entities) which were similar to those in the Enron scandal, but which did not constitute intentional malfeasance.

Issue 3: A Possible Need for using Forensic Techniques to Examine Emerging Bubbles.

Certain of the economic and financial studies noted above (e.g., Rogoff and Reinhart, 2011, 2012; Herrera et al., 2020) have documented that economy-wide, non-fraudulent forces cause pre-crisis asset bubbles. These factors include low interest rates; political leaders and regulators who engage in ideologically driven financial deregulation (Herrera et al., 2020); moral hazard caused by the belief that large financial institutions will be bailed out (Calomiris and Haber, 2014; Financial Crisis Inquiry Commission, 2011); rapid advancement in (unregulated) financial innovation (Barth et al., 2009); and an investor "herd" belief that asset prices will rise indefinitely (Reinhardt and Rogoff, 2011, 2013).[17]

These non-fraudulent factors, especially rapid unregulated financial innovation and investor exuberance may render detailed accounting rules obsolete or irrelevant. Accordingly, applying and attesting to the value of bank loans based on GAAP may result in unreliable loan accounting. Independent forensic accountants possess skills (e.g., valuation,

[15] For summaries of some of the classic models of auditing and bank loans, see Freixas and Rochet (2008).
[16] For example, no accounting professionals or regulators testified during the late 1990s hearings to "modernize" the U.S. financial regulatory system which resulted in the 1999 Gramm-Leach-Bliley Act. Such participation may have been crucial, given that the Act allowed banks to merge with non-banking financial services firms, and would thus have benefitted from testimony on consolidation accounting for financial institutions. The absence of accounting professionals was also notable in the hearing leading to the Dodd-Frank Act.
[17] Within this context, individual scandals involving intentional fraud occur (e.g., the Madoff scandal and, arguably, Lehman Bros.), but usually reflect institution-level characteristics and actors.

investigative training) important for assessing bank loan overstatement during the building of asset bubbles.[18] However, the forensic accounting profession may consider the examination of the non-fraudulent factors which underly asset bubbles to be outside the scope of the (traditionally fraud-oriented) forensic accounting function. Thus, regulators and the accounting profession should find an arrangement in which independent forensic accountants' unique skills can examine non-fraudulent loan overstatement. This need for forensic accountants' skills exists not only in the case of weak standards, such as the QSPE concept, but also in situations, such as the 2023 collapse of Silicon Valley Bank, which require a deeper interpretation of long-standing, accepted standards (such as the valuation of Held-to Maturity Investments). The chronology and cases reviewed in this study suggest a possibility for such an arrangement.

Organization of the Study

The article's first section provides a background by summarizing the post-Enron debate on Rules-Based versus Principles-Based accounting systems in the U. S. This issue dominated regulatory discussion on the future of U.S. standard-setting in the years (2003–2008) during which the subprime bubble formed. In the second section, economic models of regulation and financial crises developed by Mishkin (1999, 2008), McCarty et al. (2013), and Calomiris and Haber (2014) are used to chronicle the evolution of the QSPE concept during the period in which the subprime bubble formed. This chronology outlines three major FASB statements (SFAS 125, SFAS 140, and FIN 46R) which formed the conceptual basis for the QSPE concept; three attempts made by the FASB to reform the QSPE concept; and the comment letters on these attempts. The impact of rules on limiting auditor judgment is then assessed by comparing the two institutions' (noted above) disclosures regarding QSPEs with their auditors' financial statement opinions. The concluding section outlines possible areas for future research and a policy implication regarding how to incorporate the skills of forensic auditors to review troubled banks' non-fraudulent loan overstatements during the building of asset bubbles.

Background: The Post-Enron Debate on Rules-Based Accounting versus Principles-Based Accounting

After the 2008 bursting of the subprime bubble, regulators and scholars questioned why the post- Enron financial reforms, particularly SOX and the creation of the Public Company Accounting Oversight Board (PCAOB), had not prevented banks from engaging in Enron-style earnings manipulation. For example, 2009 Congressional testimony by Sheila Bair, Chairperson of the Federal Deposit Insurance Corporation (FDIC), stated that Enron's 2001 Off-Balance Sheet earnings manipulations involving SPEs had served as financial institutions' subsequent model to hide subprime loans in Off-Balance Sheet SPEs.[19] Addressing the issue in a more detailed manner, 2008 testimony by Professor Joseph Mason noted that, in one of its more infamous machinations, Enron would arrange for "outsiders," with funds borrowed from Enron, to purchase at least 3% of the SPEs' stock.[20] Thus, in literal compliance with the consolidation practices of the era (FASB, 2002b, ii), Enron was not required to consolidate the financial statements of insolvent SPEs in which it had retained a risk exposure.[21,22]

[18] DeGarielle et al. (2020) synthesize the research on non-fraudulent uses of forensic accounting. They concentrate on forensic accounting in court settings. Herein, we argue that forensic auditors could use the same skills (e.g., valuation) to assess the impact of non-fraudulent factors on the building of asset bubbles.

[19] Congressional hearings before the Financial Services Committee of the U.S. House of Representatives on Regulatory Perspectives on Financial Regulatory Reform Proposals, 111th Cong., Sess. 1 (July 24, 2009) (Statement of Ms. Bair).

[20] Senate hearings before the Committee on Banking, Housing, and Urban Affairs, Subcommittee on Securities, Insurance, and Investment, on Transparency in Accounting: Proposed Changes to Accounting for Off-Balance Sheet Entities, 110th Cong. 2nd Sess (Sept.18, 2008). (Statement of Mr. Mason).

[21] The Committee on Accounting Procedure (AICPA, 1959) passed the traditional control-based model for consolidation. The rule stated that a "controlling" entity should consolidate the financial statements of a "controlled entity" when the "controlling entity" owned at least 50% of the voting stock of the other entity. In the 1980s and 1990s, the increased securitization of bank loans compelled the FASB's Emerging Issues Task Force (EITF) (1990) to require that SPEs' financial statements be consolidated with those of the originating entity if outsiders did not own more than 3% of the SPE's stock. Larson (2008) states that the 3% rule resulted from an SEC staff interpretation of EITF 90-15 (FASB, 1990).

[22] Given the historical nature of the evolution of QSPEs summarized herein, the original pronouncements are cited.

Reflecting these concerns, a 2003 SEC SOX-mandated report proposes to avoid scandals based on such "bright lines" (Tweedie, 2002) as the "3% rule" by adopting a Principles-Based accounting system in the USA.[23,24,25] In questioning the impact of rigid standards on independent auditor judgment, the final report (SEC, 2003, Section I[D]) notes that the intent of Rules-Based accounting is:

> … to minimize (and indeed in certain instances to trivialize) the judgmental component of accounting practice through the establishment of complicated, finely articulated rules that attempt to foresee all possible application challenges.

The report (2003, Section I[D]) identifies three problems with this intent of Rules-Based accounting, including that:

- "…no standard setter can ever sufficiently identify the myriad of business situations to which accounting standards must be applied."
- "… excessively detailed accounting standards fail to take advantage of the company-specific knowledge of the front-line professionals-management, accountants, audit committee members, and auditors-who are making the accounting judgments."
- "… it is simply impossible to fully eliminate professional judgment in the application of accounting standards. To pretend that standards can be written in such a manner results in both unnecessary cost and a misplaced regulatory focus."

In order to address these issues, the report (SEC, 2003) recommends that the U.S. adopt an "objectives-oriented" accounting model. This approach would require that (SEC, 2003, Section I[C]), accounting standards setters use fundamental accounting characteristics (e.g., representational faithfulness, verifiability) contained in a conceptual framework to formulate objectives (i.e., standards) on specific areas of accounting. Auditors would use the guidance to determine whether a company's financial statements have met the objectives.[26] The report (SEC 2003, Section I [C]) states that the system should: emphasize accountant/auditor judgment, reduce accountants'/auditors' reliance on detailed rules, and promote standards with fewer exceptions.

Concurrent with the SEC's efforts, in 2002, the FASB and IASB entered the "Norwalk Agreement." This arrangement proposes that the Boards cooperate on eliminating differences between U.S. GAAP and IFRS. Reflecting this cooperation, a 2002 FASB report on Principles-Based Accounting recommends the development of broad objectives based on an "improved" version of the FASB's Conceptual Framework. Similar to the SEC's report, the FASB report advocates for fewer exceptions to the standards, less interpretive and implementation guidance, and greater auditor judgment.

Despite these post-Enron regulator proposals to adopt a Principles-Based model in the USA, a 2006 study by Benston et al. notes that a long-standing contradiction between the FASB's Conceptual Framework and the American Institute of Certified Public Accountants' (AICPA) Code of Professional Conduct could obstruct these efforts.[27] On the one hand, the study notes (Benston et al., 2006, 165) that the "typical" U.S. audit opinion emphasizes a Principles-Based approach by stating that:

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[23] Senate hearings before the Committee on Banking, Housing and Urban Affairs on Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: International Accounting Standards and Necessary Reforms to Improve Financial Reporting. 107th Cong., 2nd Sess. (2002). (Statement of Mr. Tweedie).

[24] H.R. 3763, 107th Cong., 2nd Sess. (2002) (enacted), (Section 108[d]).

[25] The term "bright lines" has been applied to accounting rules based on specific values, such as the 3% rule," which financial institutions and businesses can easily violate through organizational or financial manipulation.

[26] The SEC report (2003, Sec. I[C]) differentiated "Principles-Only Accounting" from "Principles-Based Accounting." Principles-Only Accounting consists only of general theoretical principles with little ability to provide practical guidance to accountants and auditors. By contrast, Principles-Based Standards emphasized general guidance to which accountants and auditors could apply their judgement.

[27] The observations by Benston, et al. (2006) are especially relevant to the financial crisis since they involve the status of the FASB Conceptual Framework and AICPA Code of Professional Conduct in the years leading up to the 2008 bursting of the subprime bubble.

> … 'the financial statements *present fairly*, in all material respects, the financial position of X Company as of date, and the results of its operations and its cash flows for the year then ended *in conformity with generally accepted accounting principles GAAP.* (Emphasis added).

However, the study also notes that this statement is effectively converted to a Rules-Based approach in Statement on Auditing Standards 69(SAS) (.05a), in accordance with Rule 203 of the AICPA Code of Professional Conduct, which incorporates the assumption that "…' present fairly' implies that the application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and cash flows (Benston et al., 2006, 166)."

Given this contradiction, in the period (approximately 2003–2008) during which the subprime bubble expanded, official AICPA rules of ethics required banks' accountants to literally follow, "Enron-style," the detailed rules of U.S. GAAP and U.S. auditors to attest to such literal compliance. As chronicled below, during the QSPE's rise in the early 2000s and during the period in which the subprime bubble expanded, this "literal compliance" assumption would force the FASB to constantly debate banks' "stretching" of the QSPE concept.

The Financial Crisis Process and the Evolution of the QSPE Concept

A Chronological Model to Frame the Evolution of Financial Regulation and the Building of Asset Bubbles

Studies by economic and finance scholars and regulators have long noted that numerous factors create asset bubbles. These factors include macroeconomic conditions (e.g., interest rates), regulation (e.g., capital requirements), financial incentives (e.g., moral hazard), and human psychology (e.g., the herd mentality phenomenon). Given these factors' complexity and interrelations, the study of a specific crisis is best contextualized by framing it on models based on previous crises, both domestic and foreign.

In this vein, economic and financial historians (e.g., Mishkin, 2008) have formed models describing how deregulation has contributed to the building of asset bubbles during the crises experienced by both developing and developed nations in the last few decades. The perspective, expressed in four phases, includes:

Stage 1: Antecedents to Financial Crisis: Economic Growth, Slow Financial Innovation. Prior to the formation of a bubble, nations experience a period of economic growth accompanied by slow financial innovation. Examples include the post-World War II economic expansions of the isolationist economies of many Latin American countries (e.g., Baer, 1972, Thompson, 1979) and some Asian nations (e.g., Corsetti, et al., 1998) as well as the more internationalist economies of European nations and the U.S. In many of these nations/regions, retail banking systems (of various forms) underpinned growing economies and real estate sectors.

Stage 2: A Period of Financial Deregulation, Rapid Financial Innovation, and the Formation of a Regulatory GAP. After periods of slowing economic growth, nations engage in financial deregulation, including to accounting, which encourages rapid financial innovation. In developing nations, an example is the 1990s Latin American and Asian financial crises, which resulted from rapid, unregulated financial liberalization (Mishkin, 2008). In developed nations, the principal example is the late 2008–2009 global financial crisis, which resulted from unregulated financial innovation and the expansion of subprime lending (Calomiris and Haber, 2014).

Stage 3: Commercial/Political Resistance to Updating Regulation and the Building and Bursting of Asset Bubbles. Aided by obsolete regulation, resistance to regulatory reforms emerges and causes the unregulated financial innovation to facilitate the building and bursting of asset bubbles. In the 1990s developing nation crises, this resistance emanated from political leaders desirous of maintaining their popularity (Herrera, et al., 2020). In the 2008–2009 subprime crisis, resistance derived from commercial and financial interests profiting from continuous subprime lending (McCarty et al., 2013; Calomiris and Haber, 2014).

Stage 4: Post Bubble Reforms. In the post-bubble period, nations attempt financial regulatory reforms. In the case of developing nation crises, International Financial Institutions (IFI) and foreign banks require these reforms to impose financial market discipline. In developed nations, domestic authorities have generally designed reforms. In the latter case, the same interests that have caused crises have sometimes influenced reforms (e.g., McCarty et al., 2013).

In the context of this four-stage process, studies by McCarty et al. (2013) and Calamoris and Haber (2014) show how, during the period of the subprime bubble's expansion, U.S. political and financial interests strongly resisted regulatory reforms. As chronicled below, this type of resistance was reflected in the hesitancy of the FASB to cancel the QSPE concept, even as banks transferred large amounts of subprime loans to QSPEs.

The Framework of Regulation and Financial Crisis Applied to the QSPE Concept

Stage 1: Antecedents to Financial Crisis: Economic Growth and Slow Financial Innovation (1930s–1970s)

Calomiris and Haber (2014) document how, for much of its early history, the U.S. financial system was characterized by state-level banking monopolies and little interstate lending. However, the Great Depression of the1930s provided the initial impetus for greater U.S. government oversight of the fragmented system in both the capital and money markets.[28] Regarding capital markets, the Securities Act of 1933[29] requires that companies initially listing securities for public sale file a Registration Statement with financial statements audited by an Independent Certified Public Accountant. The 1934 Securities Exchange Act (Section 4)[30] created the Securities and Exchange Commission (SEC) and requires that companies continuously listing shares on securities markets also file periodically audited financial reports. In spite of these accounting and auditing authorities, in a manner that emphasizes private sector self-regulation, in the late 1940s and 1950s, the Commission acceded many of its standard-setting functions to the accounting profession (Pines, 1965).

Concurrent with this increased oversight of capital markets, from the 1930s through the 1950s, the U.S. Congress passed several laws which increased Federal oversight of money markets. Most notably:

- The Banking Act of 1933, popularly known as the Glass-Steagall Act (GSA), contained rules (i.e., "the GSA Barrier") that separated retail banking from other types of financial services (sections 16,20,21,32) and (subsection 12B) created the Federal Deposit Insurance Corporation (FDIC). [31]
- The National Housing Act of 1934 created the Federal Housing Administration, an agency that guarantees mortgages that comply with certain federal standards. [32]
- A 1938 amendment to the 1934 Act created the Federal National Mortgage Association (i.e., Fannie Mae). This Government Sponsored Entity (GSE) supports housing prices by purchasing bank mortgages and selling them in securitized form in the secondary market. In 1970, a second GSE, similar to Fannie Mae, the Federal Home Loan Mortgage Corporation (i.e., Freddie Mac) was created.
- The 1956 Bank Holding Company Act limited Bank Holding Companies to ownership in the shares of retail banks (Anonymous Author, 1957).[33]

During the 1950s and 1960s, these statutes supported a housing financing system dominated by traditional retail and savings banks. These institutions collected deposits, issued mortgages, and retained the loans as balance sheet assets (Fuster, et al., 2022). During these decades, home ownership grew (U.S. Census Bureau).

In a reflection of this simple real estate financing system, from the 1930s through the 1970s, the U.S. accounting profession's three successive accounting setting-bodies (Committee on Accounting Procedure (CAP: 1939–1959); Accounting Principles Board (APB: 1959–1973), Financial Accounting Standards Board (FASB: 1973-present)) maintained two provisions in U.S. Generally Accepted Accounting Principles (GAAP) which supported the traditional retail banking model. First, GAAP only required that banks' loan reserves be valued on an "incurred loss" basis. This method only requires

[28] Calomiris and Haber (2014, Chapters 6 and 7) describe how the Constitution affected the early U.S. financial system.
[29] H.R. 5480, 73rd Cong., 1st Sess. (1933) (enacted), (Section 7).
[30] H.R. 9323, 73rd Cong., 2nd Sess. (1934) (enacted), (Section 6).
[31] H.R. 5661, 73rd Cong., 2nd Sess. (1933), (enacted). As noted later, the "GSA Barrier" was eliminated in 1999 and is no longer relevant in current banking practices.
[32] H.R. 9620, 73rd Cong., 1st Sess. (1934) (enacted).
[33] H.R. 6227, 84th Cong., 2nd Sess. (1956) (enacted). These provisions of the Bank Holding Company Act were eliminated in 1999.

that loan reserves be calculated based on debtors' past performance. Also, GAAP only required consolidation if one entity owned at least 50% of the voting shares in another entity (AICPA, 1959).

Stage 2: A Period of Financial Deregulation, Rapid Financial Innovation, and the Formation of a Regulatory GAP (The Rise of The QSPE Concept [1996–2003])

Antecedents. In the 1970s, a drastic rise in the international price of oil and competition from nations such as Japan and Germany slowed U.S. economic growth and raised inflation and interest rates. In the early 1980s, the U.S. electorate responded by supporting a transition to the free-market-oriented policies of the presidential administration of Ronald Reagan (1981–1989) (Niskanen, 1988). These programs reduced taxes, government spending on social programs, and regulations. Despite these changes in economic policy, the FASB maintained the traditional incurred loss standard for loan valuation and the simple 50% consolidation rule (AICPA, 1959). Also, the Depression-era GSA and Bank Holding Company Act remained in force.

Contrary to this regulatory inertia, from the late 1970s and well into the 1990s, several financial market events weakened the traditionally small-bank-dominated financial system and the Depression-era financial laws**.**

- The Savings and Loan crisis of the 1980s accelerated a movement toward permitting cross-state banking and forming regional banks.
- Aided by new technologies, financial institutions began offering securities, such as mutual funds, which violated the GSA (Hendrickson, 2001).
- Banks increasingly moved their loans off their balance sheets by "selling" them to Off-Balance Sheet SPEs (Barth et al., 2009).
- The Federal government compelled the GSEs to purchase specified quotas of bank loans in low-income communities. Given the GSEs' size, these mandates lowered lending standards for virtually all mortgage categories (Calomiris and Haber, 2014).
- Supported by political leaders and high-level regulators, in the mid to late 1990s, large financial institutions, most notably Citibank and Travelers, undertook mergers which violated the GSA barrier (Hendrickson 2001, 2011).

The Citibank-Travelers merger was legally recognized on November 12, 1999, when President Bill Clinton signed the Gramm-Leach-Bliley (Financial Services Modernization) Act (GLBA).[34] The Act (Section 101) eliminated the GSA barrier and weakened the 1956 Bank Holding Company Act (Section 103) by allowing Bank Holding Companies to acquire majority interests in virtually all types of financial services firms (either as holding company affiliates or bank subsidiaries). Conservative political leaders predicted that the holding companies would benefit consumers (e.g., Gramm, 1999) and that "market discipline" and private monitors (e.g., ratings agencies and auditors) would oversee the new financial conglomerates more effectively than federal regulators. Consumer advocates, however, predicted that the structure would expose FDIC insured deposits to non-banking risk and lead to a financial crisis (e.g., Nader, 1998). Despite the latter's concerns, accounting professionals did not testify during the 1998 GLBA hearings; consequently, Congress gave little consideration to accounting changes that could more adequately accommodate the new financial structures. Nevertheless, under pressure from the SEC, the FASB undertook three efforts in the late 1990s and early 2000s to address securitization accounting.

SFAS 125 (1996): Creation of the QSPE Concept. The FASB initially attempted to address the increased securitization activity through the 1996 promulgation of Statement of Financial Accounting Standard (SFAS) 125 (Exhibit 1), entitled "Accounting for Transfers of Financial Assets and Extinguishment of Liabilities."[35] One of this standard's principal objectives was to determine the conditions under which banks' transfers of financial assets to SPEs should be treated as sales to third parties. Under such treatment, the originating entity (bank) should remove the asset from its balance

Exhibit 1: Chronology of Events in the Evolution of OBS Accounting, with an Emphasis on QSPEs

[34] H.R. 1, 106th Cong., 1st Sess. (1999) (enacted).
[35] The FASB traditionally promulgated standards in SFASs. More recently, the Board has codified the standards.

Event/Trend Date(s)	Author/Initiating Entity	Event/ Action/Trend	Relevance to the QSPE Concept
The Rise of the QSPE Concept			
June, 1996	FASB	SFAS 125 issued	The FASB issues SFAS 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities.* The QSPE concept is created
Sept, 2000	*FASB*	SFAS 140 issued	The FASB issues SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities.* The rules for obtaining QSPE status are strengthened. Adopting a risk/rewards model for QSPEs is not considered. QSPEs are exempted from consolidation.
December, 2003	FASB	FIN46R issued	The VIE concept is initiated to incorporate a risk/rewards model for financial asset transfers to SPEs. However, QSPEs are exempted from VIE risk/reward requirements. The QSPE non-consolidation rule is retained.
The Fall of the QSPE Concept			
June, 2003	FASB	Exposure Draft Issued	The FASB, based on concerns of companies' "stretching" of OBS accounting, issues the Exposure Draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of SFAS 140*. The Exposure Draft includes provisions to incorporate a risk/rewards VIE requirement for certain QSPEs. Comment letters strongly support the QSPE concept, as originally defined. The Exposure Draft is rescinded for further development.
August, 2005	FASB	Amended OBS Exposure Draft is released	The FASB issues a revised version of the Exposure Draft, *Qualifying Special Purpose Entities and Isolation of Transferred Assets: an Amendmant of SFAS 140.* This Draft again attempts to incorporate a risk/rewards model into certain SPE accounting. A limited number of comment letters oppose the QSPE concept; however, the vast majority of comment letters again support the original QSPE concept. The Exposure Draft is again rescinded.
2007-2008	Bear Stearns	Liquidation	Bear Stearns liquidates two hedge funds and is ultimately liquidated and sold to J.P. Morgan. Bears Stearns's SEC filings state that it has widely used the QSPE concept to securitize mortgage securities.
2004-2008	Citigroup	Heavy use of QSPEs	A press report emphasizes that, over a number of years, Citigroup has accumulated massive amounts of Off-Balance sheet assets and liabilities, including in QSPEs.
15-Sep-08	Lehmann Bros.	Bankruptcy	Lehman Bros.investment bank is denied bailout assistance and collapses. Interbank lending freezes.
15-Sep-08	FASB	Exposure Draft Issued	The FASB issues three Exposure Drafts. On a combined basis, they eliminate the QSPE concept. Comment letters accept the elimination of the QSPE.
18-Sep-08	U.S. Senate	Committee Hearings	The U.S. Senate Banking Committee holds a hearing, "Transparency in Accounting: Proposed Changes to Accounting for Off-Balance Sheet Entities." Witnesses recognize that the QSPE concept is not practicable.
June, 2009	FASB	SFAS 166 and 167 are issued	The QSPE concept and consolidation exception are permanently removed from SFAS 140 (which is rescinded) and FIN 46R.

sheet and recognize a gain or loss on the sale. Such transfers of assets have traditionally been evaluated on two criteria. One criterion is whether the risks and rewards associated with the asset have, completely or proportionately, been conveyed to the transferee. Factors used to measure the risk/reward embodied in asset transfers include (FASB, 1996, para. 87) "… recourse or guarantee obligations, servicing, agreements to repurchase or redeem, and put or call options on the assets transferred." Another criterion is whether "control" over the asset has been transferred to the buyer. Factors used to measure transfer of control include the transferee's ability to sell and manage the asset without the interference from the original seller.[36]

In SFAS 125, the FASB ruled that the "components" (control) view of asset transfers should govern whether financial asset transfers should receive sales treatment. This policy would allow sales treatment if a transferring entity could demonstrate that it had ceded control over the whole (or component) of a financial asset. No consideration was given to using the risk/reward view of asset transfers.

Under SFAS 125, control was ceded if a (whole or component of a) financial asset transfer complied with all of the following criteria (Kane, 1997):

- "The transferred assets, under all conditions, including bankruptcy of the transferor, have been isolated and put presumptively beyond the reach of the transferor and its creditors;
- The transferee obtains the effectively unencumbered right to pledge and/or exchange the unencumbered assets, or the transferee is a qualifying special purpose entity; and
- The transferor does not maintain effective control over the transferred assets, through either a forward contract or option, in the case of transferred assets that are not readily obtainable."[37]

The latter part of the second criterion permitted sales status if the transferee (i.e., QSPE) was an SPE, independent of the originating entity, which only held passive assets on behalf of its beneficiaries (i.e., was on "autopilot"). The FASB (2003b, para. A5) considered this type of entity to be a 'pass-through" conduit through which the cash flows from "passive" investments (i.e., investments needing no active management) were passed on to the SPE's investors (i.e., beneficial interest holders). The concept presumed that a QSPE's investors held undivided interests in the QSPEs portfolio of financial assets and that the returns of those assets were distributed to investors in proportion to their interests in the QSPE.[38]

In SFAS 125 the FASB (1996, para. 129) recognized that, under some conditions, QSPEs might require consolidation; however, the FASB reserved this issue for future consideration. The FASB's justification for this position was that (2003b, para. A7) identifying controlling financial interests is not pertinent to SPEs with passive, pass-through structures which create undivided interests in the SPEs' assets.

Nevertheless, to ensure that banks would only apply the QSPE concept to the "independent/passive" type of entity envisioned in SFAS 125, the FASB ruled that, in order to obtain "qualifying" status, an SPE was to be (FASB, 1996, para. 26):

> "… a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
>
> > (1) Holding title to transferred financial assets
> >
> > (2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization)
> >
> > (3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held.

[36] The FASB had previously used the control concept to determine asset transfer sales status with recourse (see FASB, 1983).
[37] SFAS 125 (FASB, 1996, 4) provides the same conditions. As expressed by Kane, the conditions are cited here to provide a concise summary.
[38] Regulators and accountants occasionally described QSPEs as SPEs on "autopilot."

(4) Distributing proceeds to the holders of its beneficial interests."

Also, the FASB (1996, para. 26) required that the SPE be legally "… distinct from the transferor."

SFAS 140 (2000): Refining the Control Definition of Financial Asset Transfers. Shortly after the June 1996 issuance of SFAS 125, FASB constituents requested guidance regarding how specific types of financial asset transfers could be accorded "sales status" under the "control" definition of SFAS 125. In response, in December of 1996, the Board added an agenda project to amend SFAS 125. The FASB considered several issues regarding the sales status of financial asset transfers, including (FASB, 2000, para 127):

- The conditions placed on a transferee's right to sell or pledge transferred assets.
- The circumstances under which assets transferred to a qualifying SPE and beneficial interests in those assets should appear in the transferor's financial statements.
- A transferor's right to exercise a call option in a transferred asset.

The FASB ultimately addressed these concerns with the September 2000 promulgation of SFAS 140 (Exhibit 1), "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities." This statement superseded SFAS 125 in its entirety; however, SFAS 140 maintained SFAS 125's control-based definition of third-party asset transfers. Also, the FASB (2000) attempted to prevent banks from "stretching" the QSPE concept by:

- Requiring that QSPEs be "demonstrably distinct" from the transferor (para. 36).
- Limiting the activities in which QSPEs could engage (para. 37–38).
- Limiting the types of asset sales that QSPEs could hold, with an emphasis on the characteristics of "passive assets" (para. 39–41).
- Limiting the types of disposition of assets (para. 42–45).
- Compelling financial institutions to improve disclosures regarding SPEs (Wharton, 2009).

In spite of these limitations, unlike SFAS 125, SFAS 140 (FASB 2000, para. 46) strengthened the QSPE concept by expressly prohibiting their consolidation. Correspondingly, similar to SFAS 125, in SFAS 140 the FASB did not consider adopting a risk/rewards model of financial asset transfers to QSPEs.

Financial Interpretation 46R (2003): Creating a Risk/Reward Concept of Transfers to SPEs (but with an exemption). Despite the FASB's support for the QSPE concept in SFAS 140 (FASB, 2000), in 2001 the Enron scandal compelled the FASB to consider adopting a risk/reward definition for determining whether QSPEs should be consolidated. The FASB addressed this issue with the 2003 promulgation of Financial Interpretation (FIN) 46R (Exhibit 1). FIN 46R expanded the traditional 50% (voting share) consolidation requirement (AICPA, 1959) to require a risk/rewards framework for SPE consolidation. This modification to consolidation standards was achieved through the new concept of the "Variable Interest Entity" (VIE).[39]

A VIE is defined as an SPE in which the originating entity has retained a "Variable Interest," such as a loan guarantee or liquidity support. The conditions for consolidation are that (Reinstein et al., 2006): the SPE is not self-supportive (e.g., thinly capitalized); the transferring entity has a variable interest (e.g., loan guarantee, residual interest) in the SPE; and the transferring entity is determined to be a "principal beneficiary" of the VIE.

In spite of the strong risk/rewards orientation of the VIE concept, the FASB (2003, para. E9) explicitly excluded SFAS 140 from the scope of FIN 46R, retained the QSPE concept as defined by FASB 140, and prohibited the consolidation of QSPEs (FASB, 2003, para. 4c).

[39]This concept stated that a company was controlled when 50% ownership of its voting shares had been achieved. This rule allowed entities (e.g., Enron) to gain financial control over entities without obtaining a 50% share of voting stock and permitted them to keep risky investments off their balance sheets.

The FASB (2003, para. E9) justified this continuing support of the QSPE exemption by stating that:

> "Because a qualifying special-purpose entity has such limited decision-making abilities, the Board decided that retention of the financial components approach for parties involved with a qualifying special-purpose entity was more appropriate than consolidation based on variable interests. Therefore, this Interpretation does not change that requirement."

Beyond this statement, no theoretical nor practical financial reporting reasons were given for the FASB's continuing support of the concept.

Stage 3: Commercial/Political Resistance to Updating Regulation and the Building and Bursting of Asset Bubbles (The Gradual Fall of the QSPE Concept [2003–2008]).

Antecedents. From 2003 through 2006 the Federal Reserve lowered interest rates and, consistent with its free-market regulatory philosophy, continued to use a "regulation light" policy. This approach extended the presumption that market discipline and private sector monitors could regulate the new financial conglomerates (Quirvan et al., 2014, 40). This lack of Federal oversight, combined with the GSE's weakening of lending standards, encouraged banks to lower their lending standards, increase subprime lending, and transfer large amounts of subprime loans to Off-Balance sheet SPEs, frequently designated as QSPEs. Concurrently, the number of unregulated mortgage brokers proliferated (Barth et al., 2009, 25). Political leaders promoted the increase in mortgages as evidence that the repeal of the GSA and light regulation were leading to a new "ownership society" in which unprecedented numbers of Americans would own houses.[40]

Even as political leaders touted this new prosperity, economists (e.g., Shiller, 2005) warned of an impending asset bubble. Concurrently, based on the SEC's concerns regarding banks' "stretching" of the QSPE concept to transfer subprime loans to Off-Balance Sheet entities, in 2003 and 2005 the FASB undertook two attempts to reform QSPEs. As described below, these efforts faced strong opposition from the financial industry and other constituents.

2003 Exposure Draft: Revisiting the QSPE Concept. Shortly after the 2003 promulgation of FIN 46R, the FASB (2003b, ii) expressed concern that the FIN 46R QSPE exemption had provided U.S. banks with an incentive to "… convert certain entities to qualifying SPEs to avoid consolidation" (under VIE requirements) and that a new project was needed to address "… the permitted activities of qualifying SPEs (2003b, ii)." Accordingly, the FASB issued the ED (June 10, 2003) (Exhibit 1), "Qualifying Special Purpose Entities and Isolation of Transferred Assets, an Amendment to SFAS 140."

In recognizing the need to reform QSPE accounting, the FASB explicitly admitted in the ED (FASB, 2003b, para. A6) that the original QSPE concept (in SFAS 125 and SFAS 140) embodied an overly simple view of financial asset securitizations. Nevertheless, the ED (2003b) maintained:

- SFAS 140's control definition for determining sales treatment of asset transfers;
- The three conditions in SFAS 140, including the QSPE concept, for determining whether control over a transferred item had been surrendered; and
- FIN 46R's QSPE exemption.

Similar to previous promulgations, the FASB justified its continuing support for the QSPE exemption (FASB, 2003b, para. A10) on the simple rationale that the VIE requirement in FIN 46R would render the QSPE concept "ineffective" (FASB, 2003b, para. A10).[41]

In order to reconcile this support of the QSPE concept with the need to incorporate a risk/rewards view into QSPE consolidation, the ED (FASB, 2003b, para. A6–A9) highlighted two situations where an originating entity could use the QSPE exemption to retain a risk exposure in an SPE while avoiding VIE consolidation requirements. First, the FASB recognized that liquidity facilities provided by an originating entity to a QSPE (FASB, 2003b, para. A8) could "… reduce

[40] The increase in home ownership and promotion of an "ownership society" was a central goal of the Presidential Administration of George W. Bush.

[41] Based on this rationale, the FASB (2003b, para. A10) stated that its objective was simply to clarify SFAS 140, with an emphasis on those "… portions related to permitted activities of qualifying SPEs."

the rate of return demanded by the investors in a qualifying SPE …" and "… facilitate the issuance of shorter-term beneficial interests, such as commercial paper, by an SPE holding longer-term assets." These advantages, the FASB argued, could "… enhance the return to the transferor or other holder of residual interests affected by the overall performance of the entity (FASB, 2003b A8)." Second, the FASB recognized that an SPE (transferee) might finance its long-term assets by issuing commercial paper or other debt with short term maturities. In this situation, the FASB argued that the transferee entity was "… effectively pledging and repledging the transferred assets … (FASB, 2003b, para. A6)," thus raising questions concerning control and whether the SPE (transferee) was truly passive.

The ED proposed to address these situations by imposing VIE consolidation requirements on QSPEs if an originating financial institution possessed concentrations of risk in an SPE. Three factors would suggest the presence of such risk concentration. These included (FASB, 2003b, para. A12)**:** "… (a) beneficial interests other than the most senior, (b) liquidity facilities …, and (c) discretion in reissuing beneficial interests."[42] An SPE would be denied qualifying status if two of these three conditions were present.

By the summer of 2003, the FASB had received fifty-two comment letters on the ED (Exhibit 2). These comments were communicated by Certified Public Accountants (six letters), Too Big to Fail banks (eight letters), other types of financial firms (16 letters), Government Sponsored Entities (two letters), lobbyists (eight letters), professional associations (four letters), regulators (two letters), and other constituents (six letters).[43] Two letters called for the elimination of the QSPE concept; three called for applying the risk/reward model outlined in the ED to QSPEs; and 47 letters called for maintaining the QSPE, as constructed in SFAS 140.

Exhibit 2: Support for the QSPE Concept in Comment Letters on Exposure Drafts

2003 Exposure Draft

	Supported Eliminating QSPE	Supported Maintaining the QSPE		
Type of Entity	Rejected ED	Supported maintaining QSPE with Risk/Rewards Model in Exposure Draft (supported ED)	Supported maintaining QSPE with Control Model of SFAS 124/140 (rejected ED)	Total
Certified Public Accountant	0	0	6	6
TBTF Bank	0	0	8	8
Other Financial	0	1	15	16
Government Sponsored Entity	0	0	2	2
Lobbyist	0	0	8	8
Professional Association	1	0	3	4
Regulator	1	1	0	2
Other	0	1	5	6
Total	2	3	47	52

Lobbyists include organizations which principally represent the interests of their members to Congress.

Too Big To Fail (TBTF) institutions include the 19 financial institutions designated by U.S. regulators as systemically risky.

Other Financial includes financial institutions (e.g., credit unions, community banks) which are not TBTF institutions.

Professional Associations are organizations which mainly provide their members with support and certification.

2005 Exposure Draft

[42] In addition to the provisions on participation loans, the ED (2003b, para. 3–9): provided detailed rules regarding transferors' continuing involvement in QSPEs (e.g., limitations on liquidity and loan guarantees); outlined (App. A) regulations concerning the conditions under which an expansive array of asset transfers to QSPEs could (or could not) qualify for sales status; and, required (para. 83) that multi-step securitizations involve a QSPE at all stages for a transfer to qualify for sales status.

[43] The final comment letter, from Grant Thornton, was dated August 11, 2003.

Type of Entity	Questioned or Opposed QSPE, supported Convergence	Supported Maintaining the QSPE		Total
		Supported Maintaining QSPE with Risk/Reward Modifications in the Exposure Draft (possiby with modification) (Supported ED)	Supported Maintaining QSPE without Risk/Reward Modifications in the Exposure Draft (Rejected ED)	
Certified Public Accountant	2	2	1	5
TBTF Institution	0	1	2	3
Other Financial	1	2	19	22
Government Sponsored Entity	0	0	2	2
Lobbyist	0	2	11	13
Professonal Association	3	0	1	4
Regulators	0	3	0	3
Other	0	1	2	3
	6	11	38	55

2008 Exposure Draft

Type of Entity	Affirmatively Supported Immediate Elimination of the QSPE Concept	Opposed Immediate Elimination of the QSPE Concept	Supported Gradual Elimination of the QSPE Concept	Accepted Ellmination of the QSPE Concept (Either did not mention Concept, or mentioned as a past artifact).	Total
Certified Public Accountant	4	1	2	0	7
Too Big to Fail Institution	1	1	2	0	4
Other Financial	4	2	5	6	17
Government Sponsored Entity	2	0	1	1	4
Lobbyist	1	2	0	2	5
Professional Association	1	0	1	0	2
Regulator	4	0	1	0	5
Other	1	1	0	3	5
Total	18	7	12	12	49

In one of the opposing comments, the New York State Society of Certified Public Accountants (Hoops, 2003) stated that the ED was an attempt by the FASB to close loopholes in promulgated rules and that the ED had diverged from both "… the "principles-based" approach that the FASB has proposed … and … the Securities and Exchange Commission's recently issued study on principles-based accounting in conjunction with Sarbanes-Oxley Act." Similar comments were contained in a letter from the New York State Banking Department (McEnerney, 2003).

By contrast, the Citigroup letter argued that the QSPE concept had become a normal part of business and accounting practices and that the bank used "… hundreds of qualifying special- purpose entities (QSPEs) with hundreds of billions of dollars in assets (Traficanti, 2003, 1)." Other comments opposing the ED invoked economic or financial arguments to support the QSPE concept. The American Financial Services Association (AFSA) (Gaw, 2003), for example, noted that the ED would deny sales treatment to "normal" liquidity support provided by originating entities to QSPEs. Such a prohibition, the AFSA argued, could raise transaction costs by requiring QSPEs to seek liquidity support from third parties. Given this overwhelming opposition, the FASB rescinded the ED for further consideration.

2005 Exposure Draft: Revisiting the QSPE Concept, Again. Concurrent with the FASB's delay to the QSPE reforms, from 2003–2006, the GSEs continued to lower lending standards. Consequently, banks and unregulated mortgage brokers increased subprime lending, securitized increasing amounts of subprime loans, and moved the loans to Off-Balance sheet SPEs (Barth et al., 2009). By 2004–2005 economic indicators and some economists continued to forecast that a subprime bubble was building (Barth et al., 2009).[44]

In the context of these trends, in 2005 the SEC released a report, required years earlier by SOX, on how to improve U.S. accounting for securitizations.[45] The report (SEC, 2005, 45) recommended that "structured transactions" meant to evade accounting standards be eliminated and that the FASB constrain the use of QSPEs. Also, the report expressed concerns

[44] In spite of these negative indications, during 2005 and 2006, neither the Senate Banking Committee nor the House Financial Services Committee held special hearings on the possibility of a housing bubble.
[45] H.R. 3763, 107th Cong., 2nd Sess. (2002) (enacted), (Sec. 401c).

that U.S. GAAP only addressed originating entities' involvement in the assets, but not SPEs' liabilities. Reflecting these concerns, in August of 2005 the FASB re-released an amended version of the (aforementioned) 2003 ED, now renamed as "Accounting for Transfers of Financial Assets, an amendment of FASB Statement 140" (FASB, 2005) (Exhibit 1).

One of the SEC's (2005, 46) principal concerns was that financial institutions were selling long term investments (e.g., mortgage-backed securities) to QSPEs while funding the QSPEs with short term debt (which was rolled over and managed by the originating entity). The ED (FASB, 2005, para. A29–A39) attempted to address this issue by limiting transferors' involvement in the management of QSPEs beneficial interests and the types of investments that QSPEs could hold. Also, the ED mandated enhanced disclosures regarding QSPEs.

Additionally, with a focus on participation loans, the ED (FASB, 2005, p. iii) noted that some entities had engaged in transactions designed to "… disaggregate and reconfigure the cash flows of a pool of dissimilar financial assets …" that appear "… to be substantively the same as transactions involving a qualifying SPE but are not subject to the same limitations."[46] This observation principally concerned "participation" loans in which the cash flows' risks and benefits were not, contrary to the QSPE concept, divided in a manner proportionate to participants' (including the transferor's) ownership interests.

In order to prevent such scenarios, the ED stipulated that a sale and derecognition of a financial asset transfer to an SPE could only occur if: the entire asset was transferred (and isolated from the transferor) (para. 9) to a QSPE (or other non-consolidated entity); or portions of assets were transferred (and isolated from the transferor) and the transfers met conditions which defined them as participation loans (para. 8A). Among these` conditions were that the cash flows from participation loans be distributed in proportion to each participant's ownership interest (para. 8A[b]). [47,48]

By the Winter of 2005, the FASB had received fifty-five comment letters on the ED (Exhibit 2). These letters included comments from Certified Public Accountants (five letters), Too Big To Fail Financial institutions (three letters), other financial entities (22 letters), Government Sponsored Entities (two letters), Lobbyists (13 letters), professional associations (four letters), regulators (three letters), other firms (three letters).

Compared to the 2003 comment letters, a nascent resistance to the fundamental QSPE concept had emerged in the form of a letter from a financial institution, two letters from Certified Public Accountants, and three letters from professional associations. These entities' comments generally urged the FASB to quicken efforts to converge U.S. securitization standards with IFRS.[49] Eleven other letters supported the QSPE concept, but only with the Risk/Rewards framework in the ED. Finally, thirty-eight letters opposed the reforms in the ED and supported the continuation of the QSPE concept as defined in SFAS 140.

In this latter group, some banks (e.g., Citigroup) and GSEs (e.g., Freddie Mac) noted that passage of the ED would, ironically, increase the use of QSPEs by mandating their insertion into participation loans which did not meet the proportionate return requirement. In spite of this observation, these same entities continued to support the QSPE concept on the basis that it had become a normal part of their business and accounting practices or that the ED would damage their markets. Citigroup's letter, for example, stated that:

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[46] Participation loans are created when a bank sells "pieces" of a loan to other institutions.
[47] The other conditions included that sellers of participation loans have no recourse to the transferor (or its consolidated affiliates or agents) or each other and that no participating interest be subordinated to another (para. 8A[c]). If these conditions were not met, accounting treatments other than sales treatment, such as a secured borrowing, would be appropriate.
[48] For example, if Bank A sold 50% of a 5%, $100,000 mortgage, with an 8% yield, to Bank B, sales status could be obtained if each bank received a cash flow of $2500 ($100,000 * 5% *50%), proportionate to its 50% ownership in the loan. Bank A would remove the bond from its books and record a loss. Bank B would purchase the bond at a discount. However, if Bank A compensated Bank B for the increased risk by raising the cash to Bank B beyond $2,500, the transaction would be accounted for as a secured borrowing.
[49] For example, the comment letters from J.P. Morgan (Sclafani, 2005) and Ernst and Young (2005) strongly suggested a full review of U.S. securitization GAAP, including possible convergence of GAAP with Principles-Based IFRS.

> …we continue to believe that the concept of a QSPE is a useful one, because it provides an appropriately limited mechanism for certain securitizations to be accounted for according to the underlying economics (Traficanti, 2005, 13).

Also, Freddie Mac (Woods and Evola, 2005) argued that the prohibition of sales treatment for transfers supported by (implicit and explicit) guarantees of mortgage-backed securities without a QSPE would prohibitively raise transaction costs and potentially harm the $1.2 trillion mortgage market that Freddie Mac supports. Finally, numerous small/community banks argued that the proportionate return requirement would prevent them from engaging in the common practice of separately selling the (government) guaranteed and non-guaranteed portions of participation loans. Given these arguments, from both small and large entities, the FASB again withdrew the ED for re-deliberation.

Stage 4: Bursting of the Bubble and Post-Bubble Reforms

In 2006, economists warned that a real estate bubble was forming (e.g., Shiller, 2005). High level regulators, however, maintained their "light regulation" policy and continued to argue that self-policing markets and private sector monitors would limit any bubble to the subprime sector of the market (Bernanke 2007; Braunstein, 2007). Correspondingly, between 2004 and 2006, key Congressional Committees held no specific hearings to consider the possibility that a housing bubble was forming.

Economists' warnings, however, began taking fruition during 2007–2008, when subprime borrowers' increasing defaults (Barth et al., 2009) forced some major financial institutions to disclose that they had used the QSPE exception to obscure large exposures to subprime loans (Exhibit 1). One notable example was the case of Bear Stearns which, in March of 2007, was forced to liquidate two hedge funds "housing" considerable amounts of subprime loans in QSPEs. In another notable example, one report (Keoun, 2008) stated that, as of March 31, 2008, Citigroup had $1.1 trillion in OBS entities relative to a reported balance sheet total of $2.2 trillion. These entities possessed $760 billion of QSPEs and $363 billion of unconsolidated VIEs. In that same report, Citigroup claimed that its maximum exposure to these vehicles was $141 billion. Even that number, however, exceeded Citigroup's stock market value (at the time) of approximately $90 billion (Keoun, 2008).

Concurrent with these disclosures, a February 15, 2008, letter by a member of the FASB's Investor Technical Advisory Committee (ITAC) (Ciesielski, 2008) communicated to the FASB that SFAS 140 and FIN 46R had not provided "… meaningful information …" about the potential risks associated with banks' Off-Balance sheet accounting. Such investor concern, together with pressure from regulators, compelled the FASB to vote (April 2, 2008) to eliminate the QSPE concept, from both SFAS 140 and FIN 46R, in a future version of the two previously rescinded EDs (Orenstein, 2008).

Nevertheless, the need for a final standard became apparent when, on September 15, 2008, U.S. investment bank Lehman Brothers collapsed (Exhibit 1) and inter-bank lending froze. In the bank's post-bankruptcy court hearings, no fraud was charged. However, the court examiner (Valukas, 2010) emphasized that Lehman had engaged in its deceptive "Repo 105" transactions to reduce its leverage. Despite this deception, the bank's auditors issued unqualified audit opinions on the bank's financial statements.[50] The examiner's report subsequently noted (Valukas, 2010) that the auditors had not adequately examine Lehman's justification for the transactions' accounting treatment nor the materiality of the transactions on Lehman's financial statements.[51]

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[50] Repurchase Agreements (REPOs) are generally short-term (e.g., overnight) loans collateralized with high-quality assets. Under traditional accounting treatment, the collateral (asset) remains on the debtor's balance sheet, while the borrowed cash and related debt are recorded on the balance sheet. Under the "105" transactions, Lehman used a loophole in SFAS 140 and a British legal opinion to justify treating the repo transactions as sales of the collateralized assets. At the reporting date, the bank would reduce its balance sheet and use the cash from the repo to reduce its debt. Lehmann would then reverse the transaction after the balance sheet date. Lehman had increasingly used this type of transaction since 2001. The bankruptcy court examiner noted the Ernst and Young did not investigate the bank's increasing reliance on these transactions to lower its reported debt.

[51] Lehman's auditors, Ernst and Young, issued an unqualified opinion on the bank's 2007 financial statements. However, the bankruptcy court examiner's report (Valukas, 2010) concluded that the auditors most likely possessed full knowledge of the manipulative intent of the REPO 105 transactions. In interviews with the examiner, the auditors stated that they had only opined on whether the

On the same date as the Lehman collapse (as part of three related EDs), the FASB issued a revised ED of the twice-delayed standard, "Accounting for Transfers of Financial Assets- an amendment of FASB Statement 140*"* (FASB, 2008) (Exhibit 1). This version removed the QSPE concept from U.S. GAAP, required consolidation of former QSPEs, and promulgated new standards based on the VIE concept.

Pressure for the approval of the final standard mounted as the Senate Banking Committee held a hearing entitled "Transparency in Accounting: Proposed Changes to Accounting for Off-Balance Sheet Entities" on September 18, 2008 (Exhibit 1). Eight witnesses, including two SEC representatives and two FASB representatives, agreed that the QSPE concept was invalid (i.e., the concept of a totally passive investment portfolio was not possible) and that it should be eliminated from U.S. GAAP (SFAS 140 and FIN 46R).

By the Winter of 2009, the FASB had received forty-nine comment letters on this version of the ED (Exhibit 2*)*. Eighteen letters affirmatively stated that the QSPE concept should be eliminated immediately; twelve supported the QSPEs' gradual elimination through a convergence process; twelve letters accepted the immediate elimination of the QSPE concept as a "fait accomplice" (by not mentioning the QSPE concept and commenting only on other parts of the proposal); and, seven letters expressed support for the concept. [52, 53,54] Despite the latter, given the reality of the bubble, in 2009 the FASB finally accepted that the QSPE concept was invalid and permanently removed QSPEs (Exhibit 1) from U.S. GAAP through the promulgation of SFAS 166 and 167. [55,56,57]

During the ensuing years, authorities undertook several legislative and regulatory initiatives. Some did not directly address (or were not relevant to) accounting's role in the crisis. Congress approved the Troubled Asset Relief Program (TARP) in the Fall of 2008. The bipartisan Financial Crisis Inquiry Commission (2011) investigated the causes of the crisis. Reflecting the politically diverse views of its members, the Commission's report blamed the crisis on poor regulation, moral hazard caused by government promises of bank bailouts, out of control GSEs which lowered lending standards, and greedy banks.

Other forums, however, partially blamed accountants for the crisis. In a March 12, 2009, special session of the House Financial Services Committee (U.S. House of Representatives, 2009), legislators and authorities argued that "Mark to Market" accounting had caught banks in a vicious cycle of increasing loan losses, decreasing equity, and pressure on their capital. In response, the FASB softened Mark to Market rules in early April of that year. Also, during the U.S. Senate Banking Committee's Dodd-Frank hearings, bankers blamed their loan losses on the FASB's Mark to Market standards and argued for a regulatory structure in which neither accountants nor the SEC would be involved in setting accounting standards which affect systemic risk (e.g., Patterson, 2009, 8).

Two Examples of Rules-Based Auditing of Banks' "Stretching" of the QSPE Concept

As described above, SFAS 125 and 140 originally afforded sales treatment to transfers of financial assets to QSPEs. The FASB based this treatment on the transferor's ceding of control over the transferred asset; however, no consideration was given to whether the transferor had retained the risk and rewards associated with the transferred asset. After the Enron

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theory"(Valukas, 2010, 949) of the sales treatment transactions corresponded with the "control" definition of asset transfers in SFAS 140. The auditors did not examine the materiality of the transactions' impact on Lehman's financial statements, including its reported level of leverage (Valukas, 2010, 954). Thus, the auditors' unqualified opinion not only affirmed Lehman's erroneous treatment of the REPOs but implicitly misrepresented that the auditors had obtained evidence to support the statement that the REPOS had not affected the financial statements "… in all material respects."

[52] The final comment letter was dated February 8, 2009.

[53] For Example, see Lockhart (2008).

[54] For example, see Frye (2008).

[55] Financial Accounting Standards Board (2009a). SFAS 166 eliminated the QSPE concept from both SFAS 140 and FIN 46R.

[56] Financial Accounting Standards Board (2009b). Given the elimination of the QSPE concept, SFAS 167 (para. 3b) provided two new criteria for determining the principal beneficiary of a VIE. These included that the beneficiary had the power to direct the activities of the VIE and the obligation to absorb potential losses.

[57] These requirements are now codified FASB ASC 860-10-40-5 addressing accounting for transfers as sales and ASC 810-10-65 addressing timing to implement new VIE consolidations.

scandal, under the VIE concept, FIN 46R required that a transferor consolidate an SPE in which the transferor had retained a variable interest (including liquidity support and loan guarantees); however, QSPEs were exempted. By the FASB's own admission, this exemption provided banks with an incentive to transfer assets to entities designated as QSPEs, but in which the bank had maintained a risk exposure. As described below, Bear Stearns's and Citigroup's financial statements not only confirmed the FASB's expectations concerning the QSPE exemption, but also suggest that their auditors focused on assessing the banks' compliance with the QSPE concept rather than on the reliability of the banks' financial reporting for QSPEs.

Bear Stearns

Prior to the 2008 subprime crisis, Bear Stearns possessed a reputation for engaging in aggressive, risky trading and investing (Mizrach, 2013). In the early and mid-2000s, Bear Stearns lived up to this reputation with the founding of two highly leveraged hedge funds ((High-Grade Structured Credit Strategies Fund (2003) and the High-Grade Structured Credit Enhanced Leverage Fund (2006)) with large exposures (in some form) to subprime loans. Regarding its use of QSPEs, Bear Stearns's November 2006 10K (p. 58) states that:

> "The majority of the SPEs that the Company sponsors or transacts with are QSPEs, which the Company does not consolidate … QSPEs are entities that have no discretionary activities and may only passively hold assets and distribute cash generated by the assets they hold. The Company reflects the fair value of its interests in QSPEs on its balance sheet but does not recognize the assets or liabilities of QSPEs. QSPEs are employed extensively in the Company's mortgage-backed and asset-backed securitization businesses."

In spite of this admitted and expansive use of QSPEs, neither Bear Stearns' 2006 10K nor its February 2007 10Q disclose the amounts and types of securities associated with its QSPEs. Nevertheless, the institution's auditors provide an unqualified opinion on its 2006 10K (p.78). The opinion states that:

> In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of The Bear Stearns Companies Inc. and subsidiaries as of November 30, 2006, and 2005, and the results of their operations and their cash flows for each of the three years in the period ended November 30, 2006, in conformity with accounting principles generally accepted in the United States of America.

Despite these assurances, in early 2007, defaults in the funds' underlying subprime loans accumulated. Consequently, in June 2007 Merrill Lynch revoked collateral and both funds failed in the next month. Shortly thereafter, Bear Stearns transferred the funds' remaining assets to its own balance sheet. In a sign that Bear Stearns had greatly "stretched" the QSPE concept, in the quarter ending February 2008, the firm's SPEs' values declined by 32.5% (Mizrach, 2013). In March of 2008, J.P. Morgan purchased Bear Stearns in a government-arranged acquisition.

Citigroup

While Bear Stearns is known as one of the institutions which signaled the start of the crisis, Citigroup is known as the bank which ultimately required the greatest amount of post-crisis bailout assistance. During the building and subsequent bursting of the subprime bubble, Citigroup's loan portfolio reflected the gradual increase in loans and the sudden "catchup" adjustments to loan reserves often seen in credit bubbles (Beattie et al., 1995).

The bank's 2004–2007 balance sheets show (Exhibit 3, Diagram 1) that, from 2004–2007, Citigroup's loans increased from over $500 billion to nearly $800 billion. From 2004–2006, loan reserves (as a percentage of total loans) decreased. However, in 2007–2008, when subprime borrowers began defaulting, the pattern reversed, as loans decreased, and reserves rose.

A similar pattern is seen in Citigroup's income statement (Exhibit 3, Diagram 2). From 2004–2007, the bank's reported interest income doubled (from approximately $60 billion to over $120 billion). From 2004-2006, the loan provision (as a percentage of income) declined slightly. However, as a percentage of interest income, the provision rose in 2006–2008, but declined in 2009–2011.

Exhibit 3: Trends in Citigroup's Loans and Loans Reserves, 2004–2011

Diagram 1: Trends in Loans and Loan Reserves

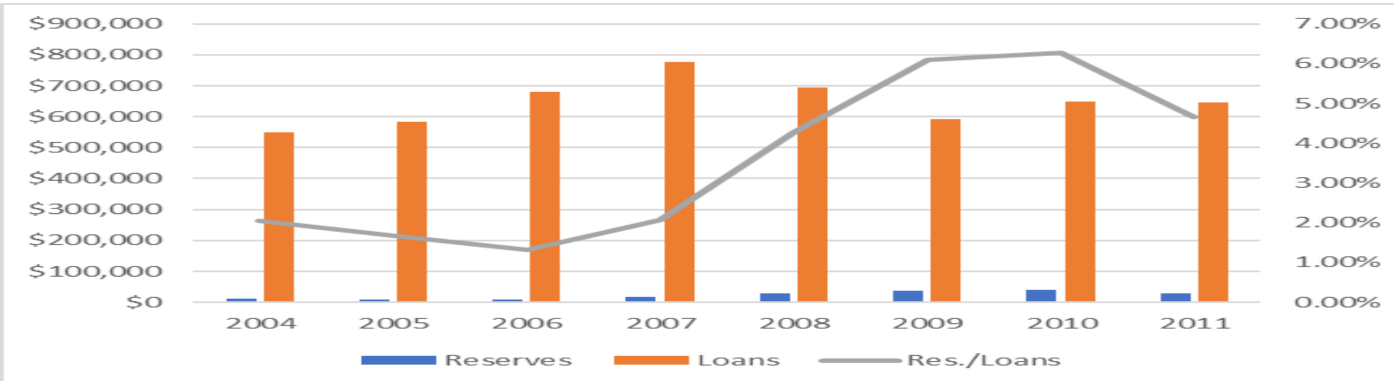


Diagram 2: Trends in Loan Provision and Interest Income

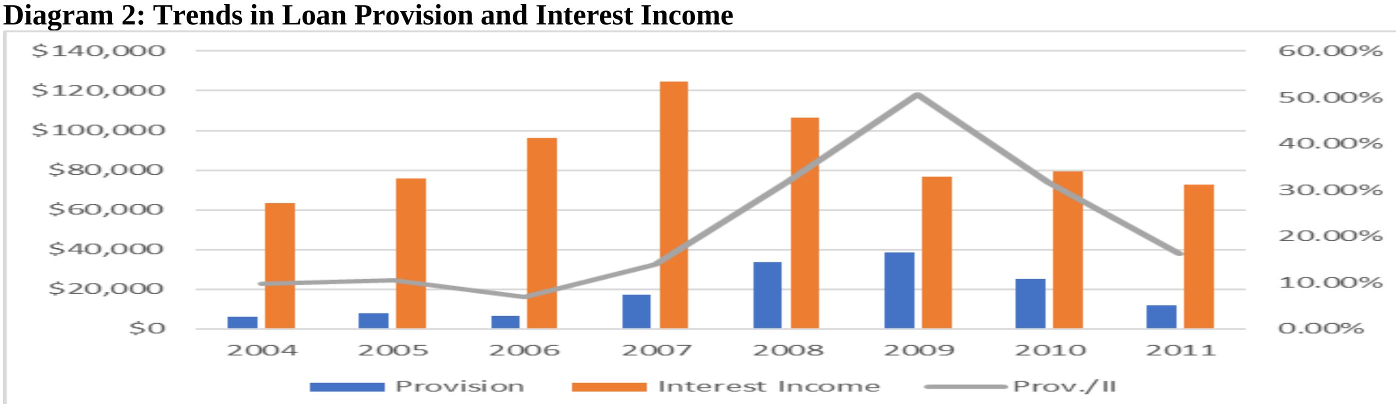
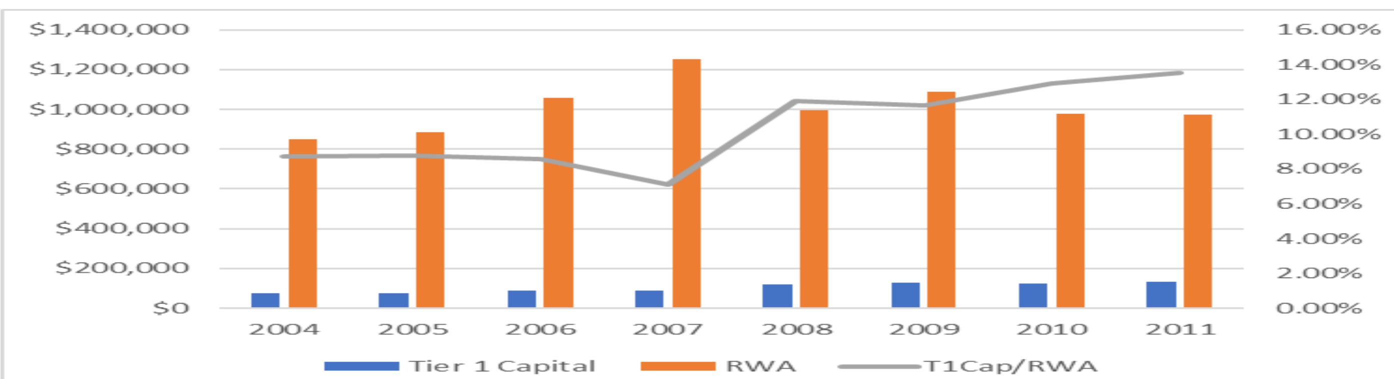


Diagram 3: Trends in Citigroup Capital, 2004–2011



RWA is Risk-Weighted Assets.
Source: Author's elaboration from Citigroup Annual Reports.
Monetary amounts are in millions of dollars.

In spite of this volatility in the bank's loan portfolio, the bank's Tier 1 capital ratio (Exhibit 3, Diagram 3) seemed stable. From 2004-2006, the ratio remained at approximately 8%. In 2007, the ratio declined to under 8% as risk weighted assets rose sharply. Beginning in 2008, however, the ratio rose as Tier 1 capital increased and risk weighted assets declined.

From 2004–2009, in compliance with SFAS 140 and FIN 46R, footnote 1 to the bank's financial statements describe the bank's financial reporting with respect to both the transfers of financial assets to Off-Balance Sheet entities and the consolidation of SPEs. Regarding asset transfers, the note (Citigroup, 2009) states:

> If it is a sale, the transferred assets are removed from the Company's Consolidated Balance Sheet with a gain or loss recognized. Alternatively, when the transfer would be considered to be a financing rather than a sale, the assets will remain on the Company's Consolidated Balance Sheet with an offsetting liability recognized in the amount of proceeds received.

Regarding SPE consolidation, the note (Citigroup, 2009) states:

> If the securitization entity's activities are sufficiently restricted to meet accounting requirements to be a qualifying special purpose entity (QSPE), the securitization entity is not consolidated by the seller of the transferred assets. If the securitization entity is determined to be a VIE, the Company consolidates the VIE if it is the primary beneficiary.

Corresponding with the latter statement, the bank used QSPEs extensively (Exhibit 4, Diagram 1). As of June 2008, the bank's QSPEs and unconsolidated VIEs were over 55% of its total balance sheet assets; its QSPEs constituted approximately 40% of assets; and its unconsolidated VIEs constituted approximately 15% of assets. Also, for most of the period 2008–2009 (Exhibit 4, Diagram 2), securities backed by mortgages and credit cards, types of loans susceptible to consumer defaults, constituted the vast amount of loans (securities) in the bank's QSPEs (mortgage loans consistently exceeded $600 billion while mortgages and credit-card loans totaled to over $700 billion). In 2009–2010, the implementation of SFAS 166 and 167 forced Citigroup to consolidate all its QSPEs; however, the bank simultaneously deconsolidated some of its (previously consolidated) VIEs. As a result, even after the implementation of SFAS 166 and 167, the bank's Off-Balance Sheet assets, all in the form of VIEs, totaled to over 30% of its balance sheet assets (Exhibit 4, Diagram 1).

According to the bank's reported proforma disclosures (Exhibit 5), the adoption of SFAS 166 and 167 only slightly impacted its regulatory capital: Tier 1 Common Capital decreased by 1.39; Tier 1 Capital decreased by 1.41, and Total Capital declined by 1.43. In each case, the pro-forma capital ratio remained above the generally accepted minimum level of 8%.

Similar to the case of Bear Stearns, the bank's auditors provided Citigroup with unqualified audit opinions in the years surrounding the 2008 crisis (Exhibit 6). Starting in 2004, for each year the opinion paragraph stated that Citi's financial statements "fairly presented" the bank's financial position, results of operations, and cash flows "… in conformity with U.S. Generally Accepted Accounting Principles." In only two cases did the opinion refer to the bank's use of QSPEs. The first mention was in 2004, when the bank adopted FIN 46R. The second mention was in 2010, when the bank ceased using the QSPE concept in accordance with its adoption of SFAS 166 and 167.

However, contrary to this overall picture of stability, patterns in the bank's capital suggest that, without a massive infusion of assistance from the Troubled Asset Relief Program (TARP), the transfer of the securities back to the bank's balance sheet would have had a more material impact than suggested by its statements and audit opinion (Exhibit 7). In 2008, the bank possessed Tier 1 capital of $118,758 million. This amount, however, included $70,664 million of convertible preferred stock (much of which had been issued to Federal authorities under the TARP program). In 2009, the preferred stock was converted to common stock (as shown by the decrease in preferred stock from $70,664 to $312 and corresponding increase in common capital from $70,966 to $152,388). This conversion enabled the bank to record a small increase in its Tier 1 capital (from $118,758 to $127,034). Without this TARP assistance, the bank's 2008 tier 1 capital ratio could have conceivably decreased from .1192 to .0483, well below the regulatory limit. (The lower capital ratio was computed by subtracting the $70,664 of preferred stock from the $118,758 of capital and dividing by the risk weighted assets of $996,247).

Exhibit 4 Trends in Citigroup OBS Entities, 2008–2011

Diagram 1: Trends in QSPE's and VIEs (as a percentage of assets)

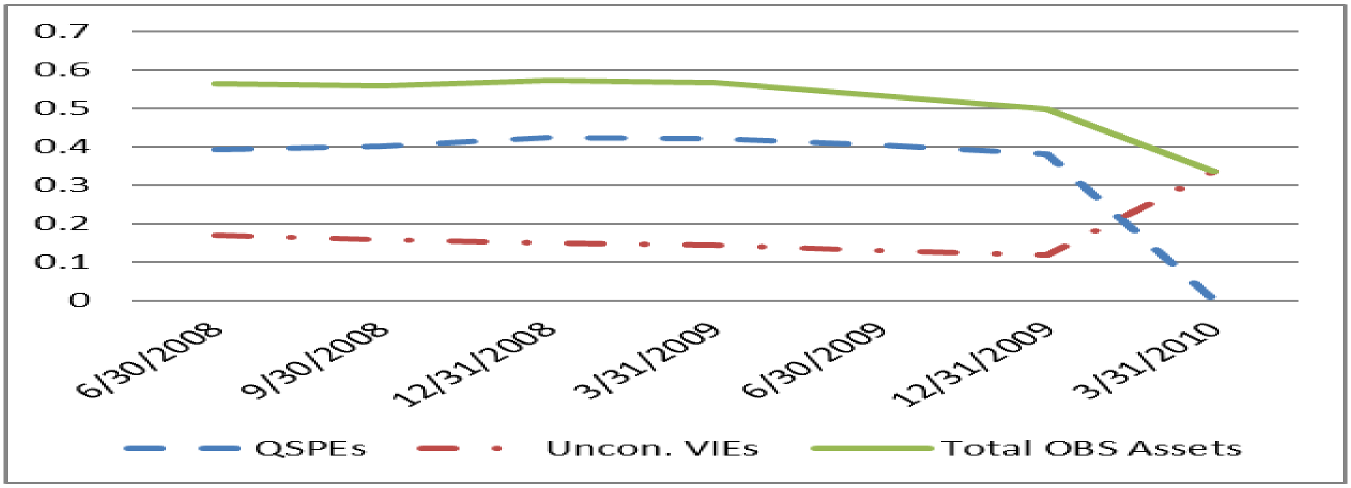
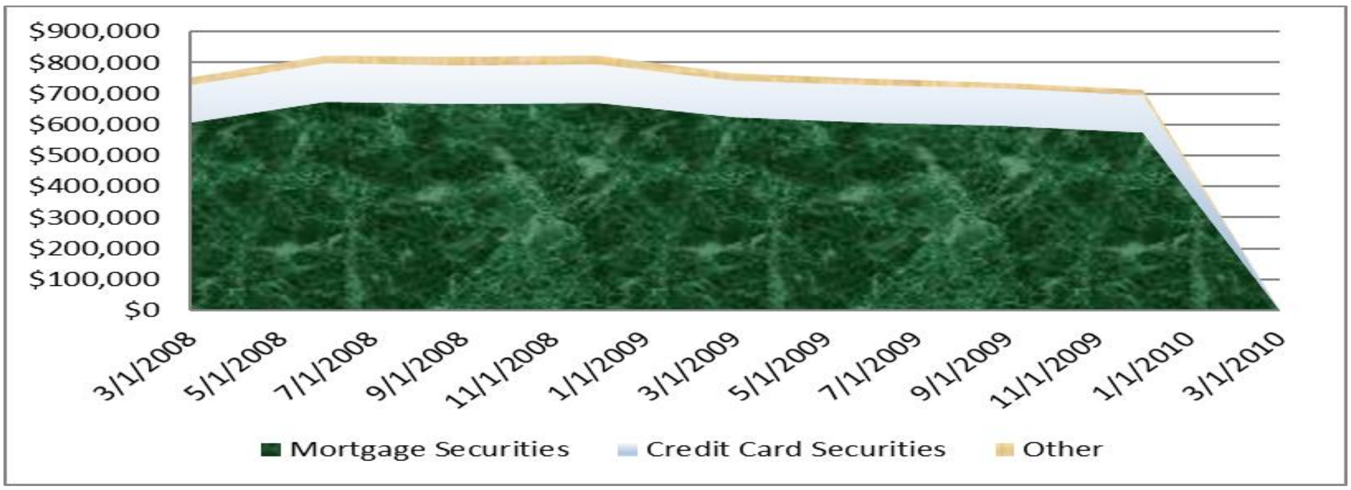


Diagram 2: Trends in QSPE by Asset Category



Source: Author's elaboration of Citigroup Annual Reports.

Exhibit 5: Impact Forecasted by Citigroup on the Bank's Capital Ratios on the December 31, 2009, of the Adoption of SFAS 166 and 167

	Reported	Pro Forma	Impact
Tier 1 Common Capital	9.60%	8.21%	-1.39%
Tier 1 Capital	11.67%	10.26%	-1.41%
Total Capital	15.25%	13.82%	-1.43%

Source: Citigroup 2009 Annual Report.

Exhibit 6: Type of Audit Opinion for Citigroup by Year

	Form of Audit Opinion	**Mention of QSPEs**
2004	Unqualified	That, starting on January 1, 1994, the Bank would adopt FIN 46R.
2005	Unqualified	None
2006	Unqualified	None

2007	Unqualified	None
2008	Unqualified	None
2009	Unqualified	None
2010	Unqualified	That, in accordance with SFAS 166, Citigroup had deconsolidated all former QSPEs.
2011	Unqualified	None

Source: Author's elaboration of Citigroup Annual Reports.

Exhibit 7: Calculation of Citigroup Capital Ratio—2008, 2009

Tier 1 Common Capital	**12/31/2009**	**12/31/2008**
Citigroup Common Capital	$152,388	$70,966
Less: Unrealized Losses on Available for Sale Securities (2)	-$4,347	-$9,647
Less: Net accumulated Losses on Cash Flows Hedges, net of taxes	-$3,182	-$5,189
Less: Adjustment Pension Liabilities, net of taxes (3)	-$3,461	-$2,615
Less: Accumulated Effect included in the Market Value of Financial Liabilities attributable to change credit, net of taxes (4)	$760	$3,391
Less: Deferred Taxes on Non-Authorized Assets (5)	$26,044	$23,520
Less: Intangible Assets:		
Commercial Credit	$25,392	$27,132
Other Non-Authorized Intangibles Assets	$5,899	$10,607
	-$788	-$840
Total Tier 1 Common (a)	**$104,495**	**$22,927**
Authorized Perpetual Preferred Capital	$312	$70,664
Subsidiaries' Available for Sale Securities	$19,217	$23,899
Minority Interests	$1,135	$1,268
Other	$1,875	—
Total Tier 1 Capital (b)	**$127,034**	**$118,758**
Tier 2 Capital		
Loan Reserves (6)	$13,934	$12,806
Authorized Subordinated Debt (7)	$24,242	$24,791
Unrealized Losses on Available for Sale Shares (2)	$773	$43
Total Tier 2 Capital (c)	**$38,949**	**$37,640**
Total Capital (Tier 1 Capital and Tier 2 Capital) (d)----(b+c)	**$165,983**	**$156,398**
Average Risk-Weighted Assets (e)	**$1,088,526**	**$996,247**
Tier 1 Common (a/e)	**0.0960**	**0.0230**
Tier 1 Capital (b/e)	**0.1167**	**0.1192**
Total Capital (Tier 1 Capital and Tier 2 Capital) (d/e)	**0.1525**	**0.1570**

Source: Citigroup 2009 Annual Report.

Discussion and Conclusion: Financial Crisis, Accounting Regulation, and the Regulatory Gap

Accounting Regulation: Constituent Resistance and the Timeliness of Accounting Standards

The chronology above demonstrates that, as the bubble formed between 2003 and 2008, the FASB's constant debates and constituents' resistance surrounding the details of QSPEs impeded the timely reform or elimination of the concept. Moreover, events (or patterns) during this period suggest that financial regulators were aware of the potential abuses of the QSPE exemption and the need to reform or eliminate QSPEs. These events include:

- the SEC's emphasis (2005) on reforming the QSPE concept;
- the known similarity of banks' Off-Balance sheet transfers to Enron's fraudulent Off-Balance sheet schemes;
- the FASB's own admission that the QSPE was an overly simplified concept of asset securitization;
- the FASB's own warnings that the QSPE exemption had given banks the incentive to use QSPEs to avoid VIE consolidation requirements;
- economists' public warnings that a subprime bubble was building; and
- the timing of the FASB's cancellation of the QSPE concept, which occurred on the same date (Sept. 15, 2008) that Lehman Bros. failed.

As shown by the 2003 and 2005 comment letters, FASB constituents' strong opposition to altering the QSPE concept in any manner was a major reason for the FASB's reluctance to reform or eliminate the QSPE. Many constituents' comments, such as those of small financial institutions, reflected legitimate business interests (e.g., participation loans) rather than any malintent. Nevertheless, regardless of constituents' rationale, few arguments against QSPE reform reflected sound financial reporting reasons. Thus, in confirmation of the SEC's (2003, Section I[D]) warnings on Rules-Based accounting, in the case of the QSPE, an emphasis on following detailed accounting standards overshadowed auditors' independent judgement. Also, no fraud was found in most of the bank loan overstatements. This seeming lack of malfeasance presumably resulted, in large part, from banks' practice of following an official, but (albeit admittedly) poor, rule.

Accounting Compliance: Auditors' Focus on Assessing Banks' Compliance with an Ineffective Rule

From an accounting compliance perspective, the examples of Bear Stearns and Citigroup suggest that, during the FASB's (2003 through 2008) delay in eliminating QSPEs, auditors issued "clean" audit opinions on banks' literal compliance with the detailed rules underlying QSPEs rather than on the auditors' independent application of their own professional judgement concerning the economic substance of the banks' subprime transfers. This auditor emphasis on assessing compliance with the QSPE concept rather than the reliability of banks' loan accounting is evidenced by:

- the issuance of consecutive "clean" audit opinions given to both institutions (especially Citigroup) shortly before the institutions' (effective) insolvencies;
- the lack of disclosure by Bear Stearns regarding the amounts and nature of its transfers to QSPEs; and
- the large amount of bailout assistance that was required to prevent the collapse of Citigroup.

Notably, regulators only pursued deeper regulatory and institutional-level reforms/investigations after the bubble had burst. At the regulatory level, the most expansive reform was the Dodd-Frank Act.[58] As in previous hearings regarding systemic risk (e.g., the GLBA hearings of the late 1990s), Congress excluded accountants and auditors from testifying. Consequently, unopposed banking interests argued that mark-to-market accounting rules had caused the subprime bubble; accounting standards should consider economic consequences; and the SEC and accountants be barred from regulating accounting matters involving systemic risk.

At the institutional level the bankruptcy most closely resembling an outright fraud was the collapse of Lehman Bros. In this case, the court examiner's report strongly rebuked Lehman's auditors for rendering an unqualified opinion

[58] The most notable case was the Valukas (2010) report, which examined the 2008 collapse of Lehman Bros. That report concluded that auditor had helped Lehman shop for accounting rules which allowed Lehman to manipulate its level of leverage.

while seemingly knowing about the bank's deliberate loan accounting manipulations. In cases involving QSPEs, such as Citigroup and Bear Stearns, regulators treated overstated loans as non-fraudulent accounting misstatements caused by accountants and auditors following inadequate accounting standards.

Even after the 2008 financial crisis, the U.S. accounting profession has kept a preference for Rules-Based accounting.[59] This penchant may reflect U.S. business culture's preference for well-defined rules. Also, many accountants (e.g., Beresford, 2002) point out that, in most cases, detailed rules provide auditors with a basis for seeking guidance on complex issues.[60] This view may be true in most situations; however, as shown by the QSPE scenario, economy-wide, rapid financial innovation may quickly render accounting rules obsolete during the building of asset bubbles.

This tendency suggests the existence of a "skills gap" that needs to be filled when considering how auditors' and forensic accountants' traditional functions and abilities may be utilized (in a Rules-Based system) during the expansion of asset bubbles. On the one hand, as bubbles form, auditors' main responsibility of attesting to the reliability of banks' loan valuations in accordance with GAAP may render opinions that are based on outdated or irrelevant rules, such as the QSPE. To the contrary, forensic auditors may possess the professional independence and skills (e.g., valuation, investigative skills) needed to detect non-fraudulent reasons (e.g., poor lending standards, overvalued loans, excess bank and debtor exuberance) for the building of some banks' asset bubbles.

Looking forward, recent events suggest that forensic auditors' skills may not only be needed in situations where financial auditors have attested to poor accounting standards, but also in situations which require a timely and deeper interpretation of longstanding, accepted standards. For example, the March 2023 collapse of Silicon Valley Bank (SVB) has been partially attributed to the large amount of investments which SVB classified as Held to Maturity (H to M). Under U.S. GAAP, H to M securities are valued at amortized cost. During times of stable interest rates, this practice may not have affected SVB's H to M securities' value. However, the Federal Reserve's doubling of interest rates in the first two months of 2023 drastically decreased the value of SVB's H to M securities and encouraged a run on the bank by large, uninsured depositors.

In response to SVB's collapse, accountants and regulators have suggested that H to M securities be marked to market (Lugo, 2023). A more timely approach, however, might have been to simply enforce current standards, which state that investments can only be classified as H to M if the investor has both the intent and ability (i.e., liquidity) to hold them to maturity.[61] In SVB's case, the bank may have possessed the intent, but not sufficient liquidity, to support the withdrawals of large, uninsured deposits. Under these circumstances, forensic accountants' skills (e.g., assessing changes in the securities' values to changes in interest rates (i.e., duration), assessing of the banks' liquidity) may have been relevant to assessing the appropriateness of the bank's classification of the securities as H to M. Arguably, these skills should have been put to use in 2019, when the Federal Reserve began expressing concerns regarding SVB's risk management (Ackerman and Michaels, 2023). As of this writing, however, the collapse of SVB has spread to other regional institutions and even

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[59] Even after these events, U.S. accounting regulators have drifted back toward Rules-based accounting model. Also, to some extent, U.S. GAAP still embody the pre-bubble contradiction between the FASB's Conceptual Framework and the AIPCA Code of Conduct which existed prior to the 2008 financial crisis. Specifically, Concept Statement 8 (FASB, 2018, p. 1), states that the objective of financial reporting is to:

> … provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.

According to the statement, this objective is achieved if financial statements are "representationally faithful," a traditional characteristic that is present if financial statements report the substance, rather than the form, of economic transactions. However, this emphasis on substance over form is still contradicted by the AICPA Code of Professional Conduct, which states (2018, 184). that an auditor will express an opinion that financial statements are not in conformity with GAAP if "…such statements or data contain any departure from an accounting principle promulgated by bodies designated by *Council* to establish such principles that has a material effect on the statements or data taken as a whole."[59]

While the bodies recognized by the Council include both the FASB and IASB, most U.S. banks still report under U.S. GAAP. Thus, the ethical obligation to attest to the literal compliance with detailed accounting rules still applies for U.S. auditors.

[60] This same view was taken by Benston et al. (2006).

[61] The standards on Held-to-Maturity Securities are provided in the FASB Codification, ASC 320-10-25-1(c).

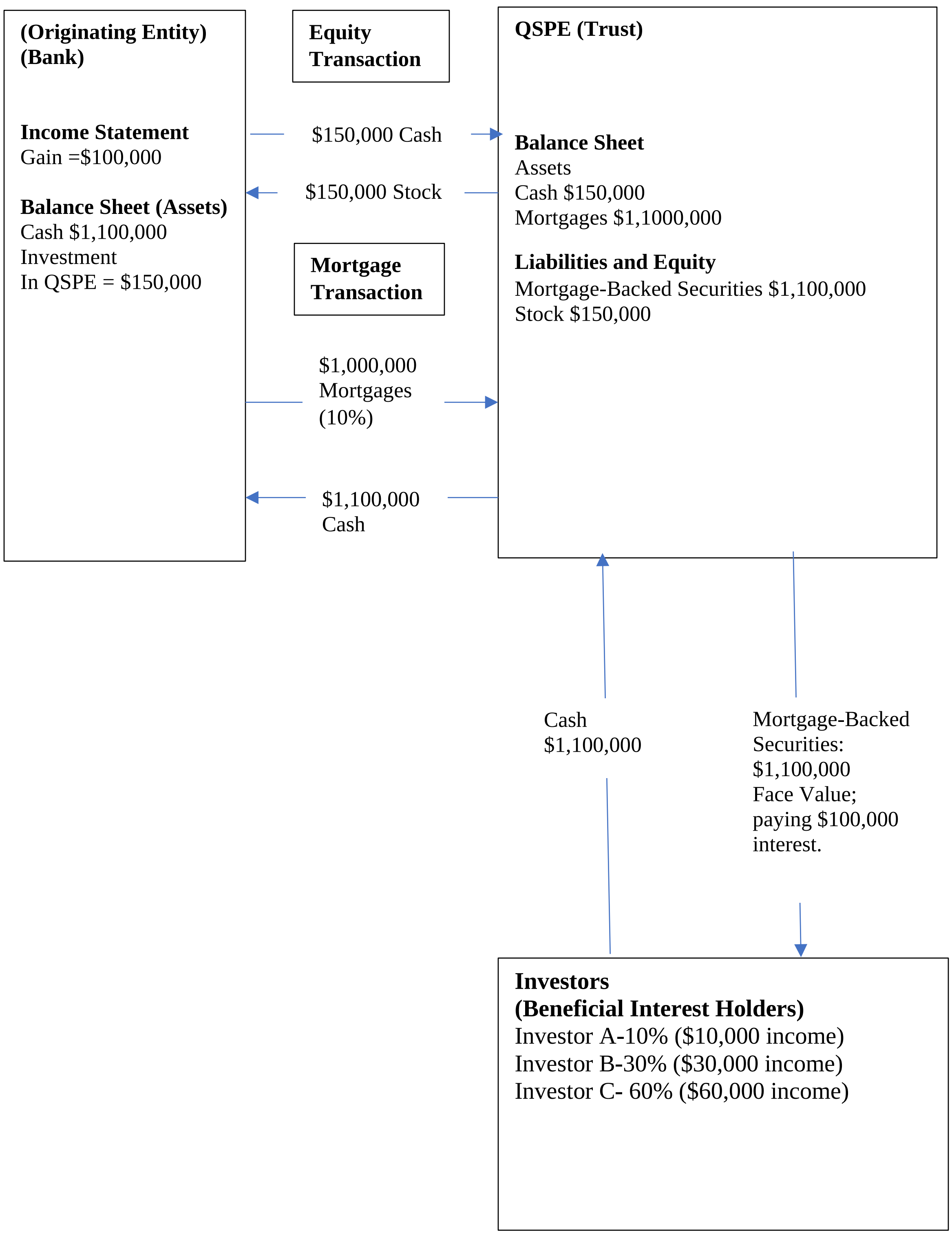
global banks. The collapse has also ignited a debate about whether cryptocurrency withdrawals played a role in SVB's collapse (Dukakis, 2023; Smith-Meyer, 2023).

In spite of the usefulness that forensic skills may play in analyzing banks' accounting, many forensic accountants may consider the examination of the non-fraudulent factors which cause asset bubbles and bank failures to be outside the scope of traditionally fraud-oriented forensic accounting. Thus, ways must be found to bring forensic accountants' skills into independent investigations of troubled banks' loan valuations before asset bubbles burst or banks collapse. From a financial system wide view, signals for such examinations could be identified as a normal part of the annual Dodd-Frank Act's review procedures, such as stress tests or tests of capital requirements. Such a process would allow routine U.S. bank audits to be conducted on the Rules-Based system, but allow for greater examination of troubled banks' loans by independent forensic accountants prior to the building of asset bubbles. Perhaps more importantly, U.S. accounting and auditing would become a more integral part of the U.S. financial regulatory system.

Appendix: Simple Concept of a QSPE

This appendix (Exhibit A1) depicts a simple concept of what may have been considered a QSPE. In the situation depicted, the originating entity is a bank which establishes the QSPE, generally in the form of a legal trust. The originating entity finances a small portion of the QSPE's capital with $150,000 stock. The originating entity also transfers $1,000,000, 10% mortgages to the QSPE for $1,100,000. The QSPE maintains the portfolio of mortgages and sells mortgage-backed securities (10% Face Bonds) to investors (beneficial interest holders) for $1,100,000. Since the SPE is classified as "Qualifying," the bank records the transaction as a sale of $1,000,000 in mortgages to the QSPE, removes the mortgages from its balance sheet, and records a gain on the sale of $100,000. The QSPE then collects the $100,000 of mortgage interest and disburses it to the investors (beneficial interest holders) in proportion to their ownership interests in the mortgage-backed securities issued by the QSPE. The beneficial interest holders have undivided interests in the QSPEs mortgages.

Figure A1: Basic Example of QSPE



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