Off-Balance Sheet Financing: An Explosive Situation?

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by

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INTRODUCTION

Statement of the Problem

Off-balance sheet debt may be the biggest mystery in corporate finance. It is impossible to estimate the amount of money owed by U.S. corporations which is not recorded in their books. Besides the hundreds of billions of unrecorded pension obligations, companies use these borrowings for things as small as office plants, and as large as oil refineries. The reason for not showing these obligations on the balance sheet is simple—past experience has shown that this practice helps improve the appearance of a company's financial position. However, this method can also backfire on the company. Sometimes an investor will overestimate a company's off-balance sheet debt which in turn makes the firm appear less attractive. This has been found to exist when off-balance sheet leases are estimated by the factor method. As the amount of off-balance sheet debt continues to grow, it is important to take a look at it to make sure that the situation is not out of hand. The purpose of this paper is to examine the effects, both beneficial and detrimental, of off-balance sheet financing.

Reasons for Increase in Off-Balance Sheet Financing

Why has off-balance sheet debt increased recently? In
the past, quality companies sold stock or fixed-income bonds to raise capital. They did not deal with warrants or adjustable-rate notes. However, recent changes in economic and business conditions, as well as tax laws, have led companies to develop new means of raising capital which offer tremendous benefits to the borrowers. Corporate finance is now applauding innovation and creativity. Even top-name companies such as American Airlines and GM are employing practices usually related to unseasoned companies. In addition to traditional securities offerings, these large companies are devising new twists in lease agreements, and leaving the tabs of new plants and buildings for the customer to pick up. Blue-chip companies that once looked down upon off-balance sheet schemes are now using them due to the irresistible savings in interest costs.

PARTICIPANTS IN OFF-BALANCE SHEET FINANCING

Companies such as GM are not the only new players entering the off-balance sheet financing game. Other players include the public, insurance companies, and the bank. The public is playing the role of equity participant as well as lender. Insurance companies which traditionally sought long-term fixed-income commitments, are now favoring agreements with built-in inflation protection. At the same time, banks, realizing that there is money to be made, are competitively seeking the project financing business from top-notch corporations.
Leases

Numerous financing mechanisms that do not show up on the balance sheet as debt have been tried. Out of these, leases appear to be the most popular. Companies may wish to lease assets instead of borrowing the money to purchase them because of the following reasons: it protects against the risk of obsolescence, it does away with maintenance and servicing problems, and it can qualify for tax benefits. A number of firms believe that leasing provides them with more financial leverage compared to debt financing. Since some leases are structured so that they do not have to appear on the balance sheet, companies believe that investors will sometimes ignore these off-balance sheet liabilities. Likewise, companies realize that certain investors will attempt to add these obligations back into total debt, but will underestimate them. The company is still provided with more financial leverage. Investors are not the only ones who underestimate these lease liabilities. A recent study showed that a large number of bankers and analysts believed that a company having off-balance sheet leases was more profitable than a company having the exact same obligation on the books.

On the other hand, keeping leases off of the balance sheet could decrease a company's debt capacity. Although this situation does exist, few firms ever consider it. When investors look at a company with such leases, they may overestimate them when adding the leases back into total debt.
This would make the firm appear less attractive than if it would have capitalized its lease obligations and included them on the balance sheet. The end result of this could be a possible increase in borrowing costs and a decrease in available credit to the company.¹¹

**Product Financing Arrangements**

Product financing practices are another common type of off-balance sheet financing. An example of this is when a company sells its product, but agrees to buy it back at a subsequent date. In the past, it was acceptable for the seller to record this transaction as a sale and not acknowledge any related obligation. This would overstate the seller's sales and understate his obligations on the balance sheet. Product financing arrangements are characterized by the fact that the sponsor retains the risks and rewards of owning a product, while the buyer is looked upon as holding legal title to allow for financing for the sponsor's benefit.¹² In 1981 the FASB stepped in with **Statement of Financial Accounting Standards No. 49**, "Accounting for Product Financing Arrangements". The FASB believes that transactions similar to the one above are borrowing transactions and not sales. Therefore, the seller should record a liability for the amount of cash received. Also finance and carrying costs, such as interest and insurance, are to be recorded as accrued expenses when incurred by the seller. All product financing arrangements occurring after June 15, 1981 must conform to this statement.¹³
THE METROMEDIA CASE

One of the more recent examples of using off-balance sheet financing to improve a company's financial statements involves the case of Metromedia Inc. Metromedia, engaged in the areas of entertainment and communication, sold the main assets of its outdoor advertising business in 1982. The purchase price was a $70 million note and $415 million in cash. Prior to this sale Metromedia had a cash deficit of $277 million. It is highly unlikely that they could have borrowed an amount comparable to $485 million at a fair rate. Thanks to the "sale" they obtained financing of almost $300 million and realized a profit of nearly $200 million on the above transaction! However, since Metromedia plans to buy back the assets in 1987, this transaction should not have been recorded as a sale.14 This is clearly a case of off-balance sheet financing.

PROBLEMS WITH ACCOUNTING CONCEPTS

An important issue with regards to off-balance sheet financing concerns the objectives of financial reporting. Does off-balance sheet financing meet these objectives? According to Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises", financial statements should provide investors, creditors, and other users with useful information to allow for the making of rational decisions concerning investment and credit. Furthermore, financial reporting should provide information
which is evenhanded and neutral. Focusing on off-balance sheet financing, the statement says that reporting should supply information about the obligations of a business to transfer resources to other businesses or owner's equity. This information is of utmost importance for investors and creditors who wish to measure the financial strengths and weaknesses, as well as the liquidity and solvency, of a company.\(^{15}\) When a company leaves some of its debt off of the balance sheet, creditors and investors alike may be misled. Because of the understatement of obligations the company may appear to be stronger financially. A company that does not include such debt on the balance sheet is not fully meeting the objectives of financial reporting.

Next we must consider if the use of off-balance sheet debt impairs some of the qualitative characteristics of accounting information. A central theme to accounting is that the information presented should be reliable. This means that the information represents what it proposes to represent, and that the user of the information has some type of assurance. The characteristic of completeness is included in reliability. Completeness states that all material items which are necessary to validify that the information represents the supporting events are to be included. Likewise, completeness is also necessary for relevance. If a relevant bit of information if left out of the statements, the relevance of the entire statements is affected. Thus completeness is required for the two main qualities (reliability and relevance) that make accounting information useful.\(^{16}\)
Financial statements that understate a company's liabilities due to off-balance sheet debt are not considered complete, nor are they considered reliable. The use of off-balance sheet financing produces accounting information which lacks certain desired qualitative characteristics.

**BENEFITS OF OFF-BALANCE SHEET FINANCING**

The advantages of off-balance sheet financing are numerous. The companies that use these techniques seem to be the biggest beneficiaries. To begin with, off-balance sheet financing improves the appearance of a company's financial statements. Also, a company in poor financial condition can acquire funds through these schemes that it probably could not obtain from a bank. The case involving Metromedia serves as a testimonial for this. Another advantage for companies is that they can often times save money by using off-balance sheet financing. These techniques sometimes provide the borrower with a lower interest rate than that of the banks. Companies are not the only ones benefiting from off-balance sheet financing. Banks, insurance companies, and the public are getting involved and making money from such arrangements.

**DETRIMENTS OF OFF-BALANCE SHEET FINANCING**

Along with the benefits of off-balance sheet financing come certain disadvantages. A major disadvantage or detriment, is that certain users of financial statements may be misled if the company has off-balance sheet debt. An investor may overestimate the well-being of such a company, or a bank
might make a loan which the company has little chance of repaying. Unless the users of financial statements take the off-balance sheet debt into account, it is highly likely that they will not be able to properly assess a company's condition. Perhaps the greatest detriment of off-balance sheet financing is that it contradicts some of the basic concepts of accounting, as well as certain authoritative pronouncements. A basic concept requires companies to supply information about their obligations. Off-balance sheet debt often times disregards this concept. Likewise, a company that enters into a product financing arrangement and does not record an obligation, is disregarding Statement of Financial Accounting Standards No. 49.

CONCLUSION

Off-balance sheet financing plays a major role in corporate finance. A company that uses such financing can acquire many benefits. These benefits include improvement of the appearance of the financial statements and possible reductions in borrowing costs. However, there are detriments to off-balance sheet financing. Some companies are using such techniques to blatantly mislead users of their financial statements. More importantly, some of these practices completely disregard certain accounting concepts and authoritative pronouncements. I feel that the detriments of off-balance sheet financing outweigh the benefits. In conclusion, I believe that off-balance sheet financing has gotten out of hand, and certain measures must be taken to insure
proper disclosure of corporate obligations, before the users of financial statements lose all faith in them.
ENDNOTES


4. Hershman, p. 56.

5. Hershman and others, p. 28.

6. Hershman, p. 57.


8. Ibid, p. 56.


10. Hershman, p. 56.

11. Houlihan and Sondhi, p. 4.


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