Off-Balance Sheet Financing: An Explosive Situation?

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by

Michael D. Carder

Thesis Director

Ball State University
Muncie, Indiana
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OFF-BALANCE SHEET FINANCING: AN EXPLOSIVE SITUATION?

INTRODUCTION

The most explosive topic of corporate finance may well be off-balance sheet financing. While the amount of off-balance sheet obligations owed by U.S. corporations is impossible to determine, the use of such techniques is extensive. Tens of billions of dollars in obligations for everything from plants and buildings to oil refineries and airplanes are believed to be unreported as liabilities. Over the last several years the accounting profession has issued many pronouncements in an attempt to end off-balance sheet financing. Such attempts as FASB Statement No. 13, however, have been circumvented by the "creative financiers" who have managed to find the loopholes in the standards. The purpose of this paper is to examine some of the effects, both good and bad, of off-balance sheet financing on financial reporting.

THE REASON FOR OFF-BALANCE SHEET FINANCING

The primary reason for using off-balance sheet financing techniques is to keep as much debt as possible off of the company's balance sheet. When it is recognized that the financial statements will be used by several parties--among them bankers, investors, rating agencies, and the SEC--it is understandable that there is much pressure to
keep liabilities to a minimum. By using off-balance sheet financing to conceal obligations, companies believe that they can improve the appearance of their financial condition, which, in turn, will encourage investors and lead to higher credit ratings than the company could attain if all liabilities were reported. This belief is confirmed by a study conducted by Professor Rashad Abdel-khalik which indicated that a substantial number of bankers and analysts believe, incorrectly, that a company with off-balance sheet debt is more profitable than a company with the same debt on the balance sheet. As long as companies have such profitable reasons to keep liabilities off the balance sheet they will continue to use a variety of off-balance sheet financing methods.

METHODS OF OFF-BALANCE SHEET FINANCING

Leases

Among the off-balance sheet financing instruments, leasing is perhaps the most popular. Due to the attractiveness of leasing as a means of financing the cost of assets used in business, the number of leases has increased steadily over the past twenty years. Leases offer many benefits to the lessee. Leases protect the lessee against obsolescence, reduce the costs of maintenance, offer tax benefits and keep what is, in fact, debt off the lessee's balance sheet. In an attempt to force lessees to capitalize their leases the Financial Accounting Standards Board (FASB) promulgated
Statement of Financial Accounting Standards No. 13, "Accounting for Leases", which has been only partially successful in achieving its overall purpose.

As Statement No. 13 states, "a lease that transfers substantially all the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and an incurrence of an obligation by the lessee...". For a short period of time the criteria of Statement No. 13 did bring a halt to leasing as a means of off-balance sheet financing. Unfortunately, financial advisors for companies whose debt/equity ratios suffered from capitalization soon found loopholes in Statement No. 13. Giant lessors, particularly banks, used their computers to keep payments under 90 per cent of the fair market value of the leased assets and arranged shorter lease terms which were less than 75 per cent of the life of the assets so that their retailing tenants would not have to capitalize. The expenses involved with this procedure are often high and result in higher rents. The stockholder, therefore, pays for the privilege of being deceived.

Product Financing Arrangements

Product financing arrangements provide companies with another method of off-balance sheet financing: the product repurchase arrangement. Under such an arrangement a company sells its product to a third party and agrees to buy the product back. The third party then uses the sales and buy-back agreement as collateral and borrows money to carry the
inventory. Thus, without recording an obligation to buy the product back, the sponsor increases both its cash and sales. Since the sponsor in product financing arrangements retains the risks and rewards of ownership, the FASB believes that the economic substance of such an arrangement creates a borrowing transaction rather than a sale.

In an effort to force sponsors to record such arrangements as liabilities, the FASB promulgated Statement of Financial Accounting Standards No. 49, "Accounting for Product Financing Arrangements". Under this statement, sponsors are required to record the original purchase price or product cost of the product as a liability. In addition, the finance and carrying costs of the arrangement are to be accrued as expenses by the sponsoring company when incurred on its behalf. While Statement No. 49 covers simple repurchase arrangements, it is not all-inclusive. The pressures placed on companies to keep liabilities off the balance sheet are strong and innovative financiers are constantly looking for ways around the rules.

Accounts Receivable

Accounts receivable historically have been a popular method of off-balance sheet financing. One reason for this popularity stems from the fact that receivables can be used as financing tools in a variety of ways. One such technique employs an unconsolidated finance subsidiary which borrows money from a bank (usually guaranteed by the parent company). The subsidiary then buys receivables from the parent. As a
result, the parent has cash, the subsidiary has the shifted receivables and no debt is shown on the parent's books. Receivables can also be a financing tool without a finance subsidiary. By selling accounts receivable without recourse, but at a discount—a provision against bad debts—a company can obtain cash without recording a liability. While at first glance this appears to be no more than a sale, the company actually obtains a large sum of cash which it pays back in installments as customers pay their accounts. If that is not debt, what is?

ADVANTAGES OF OFF-BALANCE SHEET FINANCING

Off-balance sheet financing offers many advantages to companies that use such techniques. One advantage results from the fact that off-balance sheet financing improves the appearance of a company's financial statements and financial ratios. By keeping liabilities off the financial statements, a company is more likely to obtain loans from financial institutions than it could if all of the company's off-balance sheet obligations were reported. This is due to the fact that financial institutions have increased their attention to the financial strength ratios and liquidity indicators in their borrower's balance sheets and seem to believe that a company with off-balance sheet debt is more profitable than a company with the same debt on the balance sheet.

The advantage of off-balance sheet financing can be illustrated by the Metromedia case. In 1982, Metromedia,
Inc. engaged in a product financing arrangement through which it received a $70 million note and $415 million in cash. Net result: Metromedia was able to obtain $485 million which it most probably could not have obtained from a financial institution.\(^{13}\)

Through such techniques, companies are often able to arrange interest costs below the market rate. Another advantage of off-balance sheet financing results from a company's ability to obtain an asset, a truck for instance, with no down payment, thereby gaining the ability to finance 100 per cent. With such advantages, one need not wonder why even large companies like General Motors and American Airlines, who once frowned upon off-balance sheet financing, now consider every new technique developed.\(^{14}\)

**DISADVANTAGES OF OFF-BALANCE SHEET FINANCING**

Although there are significant advantages to off-balance sheet financing, companies engaging in such techniques also must accept a few disadvantages. While it has been shown that many investors disregard leases and other off-balance sheet methods of financing, some investors attempt to capitalize off-balance sheet obligations using the factor method. Unfortunately, due to the fact that FASB Statement No. 13 does not require lessees to report the present value of their off-balance sheet leases, investors often overestimate the debt equivalent amount of such leases. As a result, investors may be led to believe that a company is
more highly leveraged and less attractive than it actually is. Further, since such significant agencies as Moody's and Standard & Poor's capitalize leases using the factor method, a company's credit rating could potentially be harmed by using off-balance sheet financing.

Although the firm faces risks by using off-balance sheet reporting, perhaps the investors who rely on the published financial data incur the greater disadvantage. By assuming that the annual report of a company includes all of the company's obligations, investors are often misled into overestimating the financial condition of the company. This mistake may lead investors to make investment errors which they would avoid if they are provided with complete financial information. This aspect of off-balance sheet financing highlights the fact that the use of such techniques contradicts some of the basic concepts of accounting.

CONFLICT WITH ACCOUNTING OBJECTIVES

The purpose of off-balance sheet financing is to conceal liabilities from the users of financial statements in order to create an image of a healthier company than actually exists. This purpose conflicts with the basic objectives of financial reporting as stated in Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises". According to this statement, the objective of financial reporting is to provide information that is useful to present and potential investors,
creditors and other users in making rational investment, credit and similar decisions. The statement declares that financial statements should provide information about the economic resources of a business and the claims to those resources (obligations of the business to transfer resources to others). By concealing liabilities from the users of financial statements, off-balance sheet financiers are disregarding the objectives of financial reporting and misleading investors and creditors who depend upon reliable data. This fact also places off-balance sheet financing in conflict with the qualitative accounting characteristic of reliability.

Reliability and relevance are the two primary qualities that make accounting information useful for decision making. Reliability rests on the faithfulness with which it represents what it proports to represent, along with an assurance for the user that it is complete and neutral. Completeness states that all material items which are necessary to validify that the information represents the supporting events are to be included. Relevance is also dependent upon the completeness of information. For instance, if important pieces of information are not included in a financial statement, the relevance of the entire statement must be questioned. Completeness, therefore, is a crucial element of both relevance and reliability, the two primary qualities of accounting information.
When companies use off-balance sheet financing, they are supplying incomplete information to the users. Such information can neither be considered reliable or relevant. Thus, the accounting information of companies using off-balance sheet financing lacks the primary qualities of useful financial information.

CONCLUSION

Through the use of off-balance sheet financing, companies are able to improve the appearance of their financial statements, achieve higher credit ratings and finance assets 100 per cent. As long as off-balance sheet financing offers such profitable advantages, the use of these techniques will remain widespread. Unfortunately, the users of these financial statements, who depend upon reliable accounting information, will continue to be misled and make investment decisions based upon incorrect information. Such flawed investments could cost investors and creditors a great deal of money. As a result, investors and other users of financial statements, may lose confidence in financial accounting statements.

The Financial Accounting Standards Board is obviously aware of the dangers posed by off-balance sheet financing and has promulgated several statements which have restricted the use of such techniques. Unfortunately these statements neither protect investors from concealed obligations or achieve the objectives of financial reporting. To achieve
these objectives this writer believes that companies should be required to capitalize all off-balance sheet obligations. This solution would restore user confidence in financial statements and meet the objectives of financial reporting.
ENDNOTES


2. Ibid.


4. Hershman, p. 56.


7. Greene, p. 56.


10. Taper, p. 28.

11. Greene, p. 56.

12. Hershman, p. 56.


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