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Off-Balance Sheet Financing:
Current Techniques and Associated Risks

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Off-balance sheet financing is a practice followed by many companies. Through the use of tools such as operating leases, asset securitization, joint ventures, contracts, interest rate swaps, and in-substance defeasance of debt, firms are tailoring their balance sheets to look more favorable in the eyes of creditors, regulatory agencies, and shareholders. Keeping a liability off of the balance sheet creates the illusory effect of a stronger financial position. This effect can be observed in many areas. Shareholders as well as the business press and the general public may view the firm as being more valuable. This positive image, in turn, attracts lenders and investors which use rating methods that fail to detect off-balance sheet financing techniques. Because of the significant effects off-balance sheet financing has on the judgement of the external users of a firm's financial statements, clear disclosure of these techniques is extremely important.

Operating Leases

Perhaps the most basic and traditional type of off-balance sheet financing is accomplished through the use of operating leases. There are two basic types of leases: capital leases and operating leases. In a capital lease, a firm purchases an asset and capitalizes the costs. The capitalized asset, then, appears on the balance sheet as a noncurrent asset with a related long-term liability. If, however, an operating lease is used, the cost of the lease is expensed and the asset does not appear on the balance sheet.

For a lease to qualify as a capital lease, it must be noncancellable and satisfy at least one of the following conditions: (1)the lease transfers ownership, (2)the lease contains a bargain purchase option, (3)the lease term is greater than or equal to 75% of the leased asset's economic life, or (4)the present value of the minimum lease payments must be greater than or equal to 90% of the fair market value of the leased property. Firms negotiate leases to avoid the capital lease conditions and qualify the asset for operating lease treatment. Companies achieve numerous benefits through the use of operating leases.

One advantage of using the operating lease is that it avoids incurring a high interest expense related to a capitalized asset early in the asset's life. The effect of this avoidance is explained in the article "Use of off-balance sheet financing to circumvent financial covenant restrictions": "The operating method allows lessees with growing activities to report higher income"[El-Gazar, Lilien, and Pastena, 1988, p. 217].

Additional advantages of operating leases are cited by Richard H. Gamble in a recent issue of Corporate Cashflow, "By converting a long-term asset to cash, a company improves its liquidity, its working capital, and its current ratio"[1990, p. 29]. Liquidity is a measure of the amount of time that is expected to elapse before an asset is converted to cash. Working capital is the excess of current assets over total current liabilities. The current ratio is the ratio of total current assets to total current liabilities.

Improving liquidity, working capital, and the current ratio allows a company to incur greater debt in the form of loans- most notably those loans obtained by middle market companies that use smaller, regional banks. Creditors who search the financial statements for violations of debt covenant restrictions frequently fail to take into consideration the footnote disclosures that explain the treatment of leases. "A lot of the loan committees at local banks look at the balance sheet, not the footnotes. Some banks are quite sophisticated in their financial analysis, but plenty of banks take the balance sheet at face value"[Gamble, 1990, pg. 29]. Covenant restrictions, which are designed to protect lenders from credit risk, may be poor indicators of off-balance sheet financing. Two examples of covenant restrictions are limitations on dividend payments and issuance of additional debt.

Dividend restrictions generally occur in three forms: a declaration of dividends based on some income level, a declaration based on a key ratio, or a denial of any declaration of dividends. These dividend restrictions are based on profitability, the starting point of which is GAAP-based income. Many times there is no attempt by institutions issuing and enforcing these covenants to adjust their definition of net worth based on off-balance sheet financing.

Along with dividend restrictions, firms restrict the amount of additional debt that can be incurred. Loan covenants specify that firms have to maintain specific debt-to-net-worth or net-tangible-assets ratios. These calculations often do not take into consideration off-balance sheet financing techniques. The covenants can thus be circumvented through the use of operating leases.

An extensive study of forty-three private debt agreements negotiated prior to 1976 conducted by Samir El-Gazzar of Rutgers University and Steven Lilien and Victor Pastena of Baruch College of CUNY resulted in a concrete conclusion regarding the use of off-balance sheet financing to circumvent financial covenant restrictions: "On a total of forty-five covenant restrictions on dividends by thirty-seven firms, only two consider OBSF (off-balance sheet financing)"[1989, p.225]. In reference to restrictions on additional debt the study found, "essentially [ ] 60 percent of the agreements do not tailor the calculation of debt for either leases or any other accounting item"[1989, p.227].

The off-balance sheet financing problem is obvious from the aforementioned statistics. As Professor Clifford W. Smith, Jr. writes, "Firms have the latitude to choose the technique that makes the [covenant] constraints least binding"[1989, p. 233]. Lenders implementing covenant constraints must revise their policies to conform to the off-balance sheet phenomenon. These revisions would be the most effective method to curtail the use of operating leases to "hide" noncurrent assets on the balance sheet.

Joint Ventures and Consolidations

Another method of off-balance sheet financing has been the use of joint ventures. With this technique, companies provide funds for a shell corporation. The shell corporation is then created for an investment purpose such as research and development, so its assets and liabilities do not appear on the investing company's financial statements. Only a line item for investments appears on the balance sheet. If a company avoids consolidation of the shell corporation, an off-balance sheet situation arises.

Historically, corporations could avoid consolidation with relative ease. Under ARB 51, a company could circumvent consolidation if there was a nonhomogeneous operation of parent and subsidiary. Some of these nonhomogeneous operations related to finance, leasing ,real estate and insurance.

Recently, the implementation of SFAS 94 has largely eliminated the use of non-consolidated subsidiaries for off-balance sheet financing. As John A. Elfrink of Southeast Missouri State University wrote on a recent article in <u>CPA Journal</u>, "This new pronouncement requires that virtually all majority-owned subsidiaries be consolidated with their parent firms"[1989, p.58].

SFAS 94 has had a significant impact on many companies. The most vulnerable companies to SFAS 94 have been non-finance related parent firms with highly leveraged subsidiaries. The debt equity ratios of these companies have dramatically increased with the inclusion of these debt-ridden subsidiaries on the financial statements. "Ernst and Whinney (1987) examined the financial statements of the 50 largest industrial companies and found that the average debt-to-equity ratio will increase from .74 before consolidation of nonhomogeneous subsidiaries to 1.18 after following the new pronouncement"[Elfrink, 1989, p.60]. The higher ratio adversely affects the image of the company in the eyes of the stockholders and creditors. Firms also incur high recontracting costs to change debt covenants in order to take into account the effect that the consolidation has on the ratio requirements.

Another adverse effect of consolidation occurs when a firm uses unclassified financial statements while its subsidiaries use classified financial statements. When the financial statements are combined, users lose the ability to distinguish between current and noncurrent assets and liabilities. This loss of information defeats, to a certain extent, the purpose of the financial statements, to inform the outside public of the company's current financial position.

Despite the drawbacks of SFAS 94, the benefits of the statement far outweigh the costs of implementation. Users gain a more representationally faithful picture of the company as a

Because of its popularity, guidelines have been implemented governing the use of asset securitization. "The CICA's [Canadian Institute of Chartered Accountants] Emerging Issues Committee (EIC) has now published guidance on the controversial issue of accounting for transfers of receivables"[CA Magazine, 1990, p. 9]. Under SFAS 77 "Reporting of Transfer of Receivables with Recourse" many transactions can qualify for off-balance sheet treatment. According to the EIC, the following conditions must exist to qualify: (1)the transferor has transferred the significant risks and rewards of ownership and (2)reasonable assurance exists regarding the measurement of the consideration derived from the transfer. Because many of these transactions involve receivables, credit risk has become an important issue regarding asset securitization.

The EIC allows the sale of receivable with up to 10% of proceeds with recourse to account for reasonable losses. A 90% guarantee often does not provide the investor with enough confidence in a safe investment.

An area referred to as credit enhancement has arisen to protect the investor against a poor investment. As reported in a recent edition of Bank Management, "Credit enhancement, a new industry, has emerged to provide the expertise needed to evaluate the creditworthiness of assets"[Caouette, 1990, p. 50]. Credit enhancement uses mainly two forms of credit enhancers: bank letters of credit and financial guaranty insurance. These devices provide an excellent tool for investors to evaluate the soundness of a company's receivables and to keep the process under a reliable form of regulation.

In order to avoid this regulation, companies have turned to senior-subordinated structures to sell their receivables. Though it is not a credit enhancement technique, senior-subs divide receivables into sections and adjust interest rates of these sections according to credit risk. The more risky the receivable, the higher the interest rate received by the investor.

The wide potential application of senior-subs helps to explain their recent increase in use as a financing tool. Credit cards, an industry currently in explosive growth, are well suited for senior-subs. "Consumer assets have a loss predictability that makes investor segmentation sensible"[Caouette, 1990, p. 53]. Credit card companies can use senior-subs to avoid regulation and high start-up fees associated with asset securitization.

Though regulation seems to be effective in the use of asset securitization as a whole, more regulation is needed in the area of senior-subordinates. Perhaps requiring the use of credit enhancers for the sale of receivables would improve the situation. As long as the regulation keeps pace with the growing use of asset securitization and investors stay informed of the actions of the company through proper disclosure in the financial statements, the benefits of asset securitization far outweigh the costs associated with the technique. Companies have a reliable method of raising capital, and consumers have a safe instrument in which to invest.

Contracts

Another form of off-balance sheet financing occurs when a company uses special types of executory contracts. A popular form of contract is described in a recent article in Management Accounting. "A purchase agreement enables a business entity to finance a capital project for long-term productive capacity without having to report the related obligation on its balance sheet"[Bailey, Laibstain, and Stout, 1988, p. 35]. Two examples of purchase agreements include take-or-pay contracts and through-put contracts. Both are quite similar except that the take-or-pay contracts involve goods while the through-put contracts involve services.

Through the use of these types of contracts, a business creates a financing arrangement with a supplier. The business agrees to make minimum payments to the supplier, which, in turn, pays for the supplier's production costs and overhead. The company thus obtains the benefits of the supplier's facility without having to show the facility on the company's balance sheet. "Inconsistent methods have been used in practice to account for and disclose the unconditional obligation in a take-or-pay or through-put contract involved in a project financing arrangement"[Kieso, 1992, pg. 716]. The FASB currently has very limited requirements for disclosure of these contracts. "Their only disclosure is that they guarantee debt repayment if the project's proceeds are inadequate to pay off the loan"[Kieso, 1992, pg. 715]. The FASB must implement more stringent disclosure requirements that provide a detailed description of these contract arrangements in order to curtail the use of executory contracts as a form of off-balance sheet financing.

Interest Rate Swaps

With the volatility of today's markets and interest rates, a new financing tool has arisen-- interest rate swaps. "It has been estimated that companies swapped $80 to $100 billion in 1985 from under $10 million in 1981"[Francis, Rue, and Tosh, 1988, p. 43]. With an interest rate swap, two companies exchange interest rates through a financial intermediary. One firm exchanges its fixed interest rate for another firm's variable interest rate. The principal amount borrowed by the company does not get exchanged, only the interest payments. The firm taking on the variable rate hopes for a drop in interest rates while the firm with the fixed interest rate gains stability. Additional interest costs involved with this type of transaction can be substantial and are normally omitted from the financial statements due to lack of a pronouncement currently addressing the issue. "Because changes in the market value of fixed rate or variable rate debt arising from swings in market interest rates are not recognized under current generally accepted accounting principles, the unrealized gains or losses associated with the swapped future cash flows also are not recognized"[Francis, Rue, and Tosh, 1988, p. 45].

There are many reason companies are using interest rate swaps. Companies engage in swaps in order to gain a better control over interest rate risk. Some companies are in a better position to obtain a favorable fixed interest rate while another firm can obtain a favorable variable interest rate agreement. These firms combine their comparative advantages through swapping interest rates. Often financial intermediaries bear the credit risk thus making this type of transaction quite attractive.

Currently, there must be rules implemented by FASB outlining more complete disclosure of interest rate swaps in the financial statements. Users of the statements should be better informed through adequate disclosures concerning the commitment and interest rate risk associated with the swap.

In-Substance Defeasance of Debt

In-substance defeasance is a method of early debt retirement. What is unique about in-substance defeasance is that it does not involve the "legal" retirement of the original debt issue. A company accomplishes this retirement by transferring risk-free assets such as cash to a trust. The trust is then used to service the debt. "In such a situation, FAS 76, 'Extinguishment of Debt,' permits the transfer of assets to be treated as a debt extinguishment even though the debtor is not legally released from its liability under provisions of the debt covenant"[Bailey, Laibstain, and Stout, 1988, p. 38]. Removal of these liabilities creates an off-balance sheet situation.

Companies are enjoying improved debt-to-equity and return-on-assets ratios without incurring the costs related to early debt extinguishment. A second advantage is the ability of the company to record a gain on the transaction. "Because the cost of the purchased securities is usually less than the book value of the company's debt in times of rising interest rates, the company records a gain on its income statement"[Kieso, 1992, pg. 705]. A company should not be allowed to recognize a gain or loss on this type of transaction because the obligation is not extinguished. FAS 76 needs to be revised in order to curtail this early recognition of a gain or loss.

Liability Issues

One of the main reasons for the success and wide-spread use of off-balance sheet financing is FASB's loose interpretation of a liability. Statement of Financial Accounting Concepts Number 6 defines a liability as, "Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events"[1992, p. 191].

FASB has outlined the three essential characteristics of a liability as: (1)it is a present obligation that entails settlement by probable future transfer or use of cash, goods, or services, (2)it must be an unavoidable obligation, and (3)the transaction or other event creating the obligation must have already occurred. According to FASB, any transaction fitting these three characteristics should technically be treated as a liability.

An interesting situation arises when applying these characteristics to operating leases, an aforementioned off-balance sheet technique. An operating lease typically involves an agreement between two or more parties outlining future outlays of cash which satisfies the first characteristic. The agreement is often noncancellable which satisfies the second characteristic. The initial signing of the lease fulfills the third and final characteristic. In all appearances the present value of future cash flows involved in a lease should then be treated as a liability. The controversy surrounding the treatment of leases as a liability stems from the issue of timing. When should the contract be recognized as a liability?

A study of this issue was conducted by Yuji Ijiri as a research report for the FASB. One of his examples was take-or-pay contract and when a company is to recognize the obligation incurred. As mentioned previously, take-or-pay contracts involve a company agreeing to purchase a fixed amount of goods from a supplier in order to cover the costs of construction and operation of a supplier's production facilities. "Each of the five recognition points, namely, the delivery, segregation, production, procurement, and contract points, may be considered for recognizing the monthly purchases"[Ijiri, 1980, pg. 20]. Currently, a company recognizes the liability at the time of the monthly payments. In order to avoid off-balance sheet financing, a company could be required to recognize its obligation at the present value of monthly payments and record this liability as a noncurrent asset and related long-term liability.

As one can see through the use of leases and contracts, companies can reclassify what a reasonable observer would consider a long-term liability and create an off-balance sheet situation. One of the keys to solving the off-balance sheet dilemma, therefore, is a delineation by the FASB of situations in which to apply the liability definition and a clear framework of scenarios in which to apply timing parameters. By limiting the number of alternatives a company has in which to recognize a liability, the FASB can reduce the use of off-balance sheet financing.

Conclusion

Off-balance sheet financing is a complex issue facing the business community today. The main risk involved with off-balance sheet financing seems to lie in how a business's financial statements are used. Financial statements are the principal means by which financial information is conveyed to the public. An alteration of this financial information through the use of tailoring financial agreements in order to obtain certain financial reporting treatments is contrary to one of the basic objectives of financial reporting-- to provide information that is useful to creditors and investors.

The off-balance sheet dilemma is, in many circumstances, a matter of perception. A company and its leased assets remain the same whether the lease is accounted for as a capital lease or an operating lease. A subsidiary of a company will continue to exist whether or not it is included in the parent company's financial statements.

Although rules can be developed to reduce the use of off-balance sheet financing, new financing tools will still continue to be devised to remove assets and avoid liabilities on the balance sheet. Until FASB releases a pronouncement that comprehensively addresses the off-balance sheet problem and revises its definition of a liability, the solution lies in education. Creditors need to adapt different methods to evaluate a company's credit risk that consider off-balance sheet financing techniques. Readers of the financial statements must be educated about off-balance sheet financing issues through industry and outside publications, and, most importantly, clear disclosures in the actual financial statements. Only through an on-going educational effort will off-balance sheet risks be reduced to a minimum and the controversies surrounding off-balance sheet financing be eliminated.

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