Off-Balance Sheet Financing and the Sanctity of Corporate Financial Reporting

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Abstract
Off-balance sheet accounting is an aspect of creative accounting. The present paper, in this context, addresses the following issues:

- Exploration of the reasons why companies are induced to keep finance off their balance sheets.
- Examination of the distorting effects of off balance sheet financing.
- Examination of the various financial schemes that are currently being used to conceal debts from the balance sheet.
- Evaluation of the approaches the leading acquainting standard-setting bodies of the world have adopted to crack down on the problems of off balance sheet financing.
- Identification of the areas where regulatory gaps still exist.
- Suggesting measures for closing the regulatory gaps.

Key-Words : Off-Balance Sheet Financing; Debt; Accounting Standards; Disclosure.

1. Introduction and Background

In recent years, there has been a proliferation of financial arrangements that have enabled companies to raise finance without increasing their apparent indebtedness on their balance sheets. The practice of using finance without the involvement of the balance sheet is known as *off-balance sheet financing*. In fact, off balance sheet financing is a descriptive phrase for all the financial arrangements that result in the exclusion of debts and associated assets from the balance sheet. The Institute of Chartered Accountants of England and Wales (ICAEW) has defined off balance sheet financing as "the funding or refinancing a company's operations in such a way that, under legal and existing accounting conventions, some or all of the financing may not be shown on its balance sheet" (ICAEW, 1985).

Off-balance sheet financing is an aspect of creative accounting. Companies have the habit of being creative in the generation of financial reporting numbers; they innovate financial reporting numbers by taking advantage of the flexibility and loopholes in accounting rules

and regulatory requirements. Keeping finance off the balance sheet is one of the ways creativity is cultivated in corporate financial reporting. There is a significant difference between off balance sheet financing and other forms of creative accounting. In off balance sheet financing figures are completely left out, while in other forms of creative accounting efforts are made to manipulate figures. The transforming of a debt into an off balance sheet item requires either a reduction in one or more of the existing assets or an exclusion of one or more of the newly created assets. This balancing activity needs to be performed in order to preserve the identity of the balance sheet.

Companies are motivated to keep debts off the balance sheet for a variety of reasons. A common reason for off-balance sheet financing is to obtain funding which the company would not have otherwise been able to achieve. Off-balance sheet financing reduces the exposure to debts. If liabilities are not reported on the balance sheet, it makes the statement more attractive and stronger-looking. But, the removal of debts from the balance sheet does not absolve the company of the burden of servicing and repaying those debts. An off-balance sheet debt, like any other kind of borrowing, has to be serviced and repaid eventually.

Debt acts as a source of external capital for business. Companies use debt for several reasons. The most important advantage of debt is that it has flexibility. Companies can structure the duration and repayment of the debts to suit their requirements. Debt interest is tax deductible and debt financing gives rise to gearing advantage. There is, however, a negative aspect of the use of debt as a source of finance. Debt financing increases the company's financial risk. Companies with high gearing have an incentive to conceal the extent of their indebtedness by procuring finance and not reporting as such on the balance sheet.
In most cases, off-balance sheet financing involves the raising of cash. Generally, companies raise cash in one or more of the following ways:

- Issuance of equity
- Borrowing
- Selling of assets

A company may seek to hide its borrowing by portraying it as an issue of equity (i.e., debt structured as equity). Selling assets with recourse is another way a company can conceal its debts. Another very subtle technique of keeping debts off the balance sheet is to create non-consolidated subsidiaries. In many countries, companies set up subsidiaries, which they effectively control, but whose share capital is so arranged that they would not be considered subsidiaries under the existing legal statutory requirements. Various techniques are adopted to accomplish this.

The exclusion of liabilities from the balance sheet is against the principle of truthful financial reporting. It undermines the credibility of corporate financial statements. If liabilities are kept off the balance sheet, the users of financial reports cannot appreciate the commercial effects of the transactions entered into by the company. The exclusion of liabilities undermines the use of the balance sheet as a vehicle for assessing risk by means of the gearing ratio. Off-balance sheet financing has the potential of jeopardizing the interests not only of the users of the financial statements but also of the companies that practice it. An excessive use of off-balance sheet financing devices may even lead to the downfall of the company that practices it. There are numerous examples of corporate failures that have been caused due mainly to the adoption of various dubious accounting practice of keeping debts off the balance sheet. The most recent example is Enron. Preliminary investigations into the collapse of this seventh largest US company reveal that the use of several off balance sheet vehicles has been a major contributing factor for its ultimate downfall.

Off-balance sheet financing has become a source of great headache for the accounting regulators the world over. They are struggling hard to crack down on the unhealthy practice; several measures have already been adopted. The definition of liability has been tightened and definitive rules have also been promulgated to outlaw some specific off balance sheet financing schemes. But problems persist. The issues raised by off balance sheet financing are perhaps the most troublesome and most complex issues accounting regulatory agencies have ever addressed. The problems being caused about by off-balance sheet financing are different in many significant respects from other accounting problems. At the time an accounting regulatory agency addresses an accounting issue; its objective normally is either to add something new to accounts or to modify the treatment of an item that is already there. But, in off-balance sheet financing, the objective of rule-making becomes to stop an item being taken away from the balance sheet.

2. Objectives and Scope of The Study

The specific objectives of the study include:

- Exploration of the reasons why companies are induced to keep finance off their
  balance sheets.
- Examination of the distorting effects of off balance sheet financing.
- Examination of the various financial schemes that are currently being used to conceal debts from the balance sheet.
- Evaluation of the approaches the leading acquainting standard-setting bodies of

the world have adopted to crack down on the problems of off balance sheet financing.

- Identification of the areas where regulatory gaps still exist.
- Suggesting measures for closing the regulatory gaps.

The study aims at bringing new knowledge to the attention of accounting policy makers and at affording others interested in corporate financial reporting a better insight into the current and emerging problems facing the accounting profession.

The study, it is believed, will help policy makers to adopt policies leading to the restoration of the damage done to the sanctity of corporation financial reporting by the explosive growth off-balance sheet financial arrangements.

The sanctity of corporate financial reporting may be disturbed due not only to reasons connected with off balance sheet financing but also to factors associated with other aspects of creative accounting. But, the present study does not deal with those other aspects of creative accounting. It is concerned exclusively with off-balance sheet financing.

Off balance sheet financing is not any country-specific problem. The problem persists in almost all parts of the world. Its presence is felt particularly in those countries where companies depend on the capital market to raise their finance. This is why the study has elected to adopt a general perspective. It explores themes and illustrates phenomena by taking examples from various parts of the world. Special emphasis is, however, laid on an understanding of the Indian scenarios.

3. Data Source and Methodology

The study is basically descriptive in nature; it describes the phenomena, as they exist. In some cases endeavour is also made to go beyond merely describing the phenomena to analyzing and exploring why and how events and phenomena are occurring. In this study, no endeavour is made to test or confirm any hypothesis. The study emphasizes on gaining insights and familiarity with the different aspects of the issues being researched.

The study has been conducted based on a qualitative approach. A major part of the data collected and used in conducting the study is qualitative in nature. Qualitative approach is bound to be to some extent subjective. An endeavour has, however, been made to overcome the deficiency of the qualitative data by supplementing them, in appropriate cases, with quantitative data.

The study also uses analytical techniques to deal with conceptual issues. The key conceptual issue involved in the study relates to the determination of how liabilities should be defined, recognized and measured. There are many controversial issues in accounting for liabilities. These issues are explored in greater depth using analytical techniques.

The study has been conducted based on data collected from various sources. They include:

- Books and journal articles
- Seminar/Conference papers (both published and unpublished)
- Study reports
- Published financial statements
- Accounting standards and other official pronouncements of accounting regulatory agencies
- Personal interviews
- News papers and magazines
- Internet

Much of the information used in the study has been gathered in the course of carrying out interviews with accounting practitioners, finance specialists, accounting academicians, accounts preparers, professional financial analysts and bankers. Since the level of understanding of the different categories persons interviewed is different, it became necessary to depend on an unstructured and semi-structured qualitative interview.

4. Literature Survey

There exists a large volume of literature on the subject of creative accounting. Since off-balance sheet financing is an aspect of creative accounting, it has a fair share in that literature. But much of this literature is patchy and anecdotal rather than analytical. Ian Griffith's epoch-making book, *Creative Accounting* represents one of the first major attempts to provide an insight into the manipulative aspects of corporate financial reporting. It provides a detailed analysis of how companies massage the financial numbers they put on the financial statements. The book focuses on British scenarios. Soon after the publication of Griffith's book (Griffiths, 1986), several other accounting writers started taking interest in the subject and a good number of books and articles were published. The most remarkable among them include Shevlin (1987), Hagigi et. el. (1987), Jameson (1988), Peasnell et al. (1988), Peasnell and Yaansah (1988), Ronen et al. (1990), Kohak and Patil (1992) and Naser (1993). Ron Paterson's book (Paterson, 1993) *Off-balance Sheet Finance* is possibly the most comprehensive treatise to deal exclusively with off-balance sheet financing. In this book,

Paterson examines the various financial arrangements that have been developed over the years for enabling companies to procure finance without the involvement of the balance sheet. The book is designed to offer some insight into the thought process of those seeking to regulate the devious practices of taking things off the balance sheet.

In India, no systematic study on this vital subject has yet been conducted. The few articles that have been brought out on the subject in India (e.g., Basu, 1996, 1998) are speculative in nature and they do not offer any systematic evidence as to the practice of off-balance sheet financing in this country. The present study is a humble attempt to fill up the gap.

5. Major Research Findings

Off balance sheet financing is a complex and contentious issue. It has troubled accounting standard setters and other accounting regulatory agencies for a long time. They have promoted several measures to regulate off balance sheet financial arrangements but problems persist. The major findings of the work are as follows:

- The size and complexity of the financial arrangements that are used to avoid reporting debt on the balance sheet has increased over the years.
- Accounting regulatory agencies are trying to cope with the situation but problems persist.
- Off-balance sheet financing is an ever-changing scenario; as one requirement is brought in to better reflect the obligation from a certain transaction on the balance sheet; more sophisticated means are soon devised to take its place.
- The approaches accounting regulatory agencies have adopted to increase the visibility of debts on the balance sheet differ from one jurisdiction to another; some have preferred detailed rule-making, while others have favoured a conceptual approach.
- In India, the problem of off balance sheet financing has not reached serious proportions, but the scenario is changing very rapidly. More and more, Indian companies are being lured into adopting various subtle devices to avoid reporting debts on their balance sheets. Leasing— the oldest form off balance sheet financing started quite long back. Among other schemes— hire purchase, debt factoring, securitization; special purpose vehicles (in the form of captive finance companies) are becoming popular and growing in terms of sizes day by day. If not controlled, it seems, in the near future, it would become a serious problem by which common investors would get affected. As a result, the capital market and money market in the country will lose its importance, and not be able to function effectively in mobilizing

the finances and making it available for proper investment proposal in right time. As a result, total economy will face a slum or slow-paced situation.

Conclusion

Keeping debts off the balance sheet is a nefarious practice. It has the potential of destroying the usefulness of corporate financial reporting. But the issue is such a complex one that there is no easy answer to it. The problem of off balance sheet financing cannot be tackled in isolation. Reforms should be contemplated in different directions.

The issue has first to be addressed at the conceptual level. These should be a clear specification as to what should be on the balance sheet. The definition of "liabilities" should be tightened further and the gap that currently exists between the definition of a liability and its recognition in accounts should be narrowed down. Definitive accounting standards may be necessary to deal with certain specific off balance sheet transactions but those standards should focus more on principles than on rules. Among other suggestions, the following may also be noted:

- Betterment of existing accounting standards and introduction of relevant standards,
- Existence of principles and specific rules based standards,
- Management should be more ethical, and maintain integrity,

- Auditors should be more independent and their responsibility is to be enhanced,
- Auditors' appointment should be justified by government,
- Rotation in auditor's appointment should be made,
- Auditor should maintain integrity in discharging duties,
- Disclosure of financial reporting should be made effective and relevant,
- Users of accounting statements should be more alert about their rights,
- Certification of credit rating by credit rating agencies may be made compulsory and
- Companies should be protected from the loss of public faith.

Lastly, it may be suggested that since off-balance sheet financing is a common accounting problem facing many countries, there should be a concerted effort to eradicate it.

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