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Off-Balance-Sheet Deals: C'est la Vie?

In the eyes of the investing public, off-balance-sheet financing has fallen into disgrace. Will it deserve another look after the SEC and FASB have their say?

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After evolving over the last quarter-century into one of the most popular corporate finance tools in the United States — taking such forms as securitizations, synthetic leases, and unconsolidated entities — it seems that off-balance-sheet financing is being deconstructed in a hurry.

Under congressional mandate, the Securities and Exchange Commission has proposed a new rule that will require disclosure of off-balance-sheet arrangements in the "management's discussion and analysis" section of annual reports. In addition, the SEC is introducing Regulation G, for financial metrics that don't conform with generally accepted accounting principles (GAAP), and beefing up the requirements governing 8-K filings.

The Financial Accounting Standards Board is also doing its part to increase corporate transparency. The rulemaker has proposed that companies consolidate variable interest entities, or VIEs (until now, better known as special-purpose entities, or SPEs) onto their balance sheets. Furthermore, in November 2002 FASB issued new rules that require companies to recognize loan guarantees on their books. (For more specifics on these rules, read "Off the Balance Sheet, in a Nutshell.")

As of this writing, the rule changes (other than for loan guarantees) are within days of becoming permanent. The SEC set a January 26 deadline for the adoption of its MD&A rule; FASB expects that its guidance will be issued by mid-January.

"Unnecessary"?
Many companies whose executives have sent comment letters to FASB seem generally opposed to the new interpretation, calling it "unnecessary" and a "distortion of financial statements." Essentially, critics believe that tighter regulations will lead to more manipulation and less consolidation, and that bright-line standards will encourage the creation of new loopholes.

Apparently, financial executives would rather that FASB stick to its guns and issue a statement declaring that the use of an entity doesn't change the underlying accounting treatment of a transaction. (These comments, it should be noted, were made in response to FASB's June 2002 exposure draft.)

The spate of corporate scandals over the past 18 months has made investors suspicious of all off-balance-sheet activities, affirms John Peak, CFO of Hoffman Estates, Illinois-based Transamerica Distribution Finance. He says that Transamerica's audit committee, as well as the boards of clients involved in deals with the $5 billion financial services company, are reviewing off-balance-sheet transactions with a fine-tooth comb. Four years ago, Peak adds, Transamerica began offering joint-venture arrangements as a stand-in for traditional securitizations.

The VIE consolidation rule will also affect synthetic leases, says Peak. He contends that if FASB requires him to consolidate the synthetic lease that Transamerica now carries on its own books, he will have to rethink his strategy, since the advantages — removing debt from Transamerica's balance sheet, but retaining the tax benefit of an operating lease — would be wiped out.

FASB's rule regarding loan guarantees is another potential hot button for Peak's clients, most of which are manufacturers and distributors that offer recourse financing to retail store owners. The FASB interpretation, explains Keith Krasney, an attorney with Wolf, Block, Schorr and Solis-Cohen, mandates that at the time a company issues a loan guarantee, it must recognize the liability for the fair (market) value of the obligation it assumes.

If the interpretation is extended to include dealer-financing guarantees — this has yet to be determined — then manufacturers will have to recognize loans that enable retailers to stock their shelves and showrooms with new products.

The VIE rule may put on the squeeze in another way, notes Krasney's colleague Tom Glynn. If commercial paper conduits (CPCs) — the large multinational banks that aggregate and issue commercial paper — are required to consolidate VIEs, their capital and reserve requirements will increase accordingly.

CPCs will become stingier about issuing commercial paper, says Glynn, and corporations will either have to find capital-raising alternatives or pay more for new issues. Glynn also points out that FASB has yet to determine on which balance sheet such entities would be consolidated — the original issuer's or the bank's.

The effect on the commercial paper market could be devastating to corporate issuers, says Lloyd Gold of REL Consultancy Group, which specializes in working capital strategies. He pegs the asset-backed commercial paper market today at $713 billion outstanding, up from approximately $42 billion outstanding in 1992.

Gold also suggests that once FASB's new rules eliminate some advantages of off-balance-sheet financing, CFOs may need to squeeze more working capital out of their balance sheet before resorting to securitization.

Ready for Their Close-Up?

Companies that abandon off-balance-sheet financing will also be giving up what's widely regarded as a "cosmetic" treatment that removes assets from the balance sheet to make ratios look better.

A healthy debt-to-equity ratio helps attract inexpensive sources of capital, contends Bob Shepard, an attorney with Ballon, Stoll, Bader & Nadler and a former investment banker. Off-balance-sheet financing, adds Shepard, also diversifies funding and invites a different group of investors — with a greater appetite for risk — into the corporate fold.

Many CFOs say the effect is much more than cosmetic. They claim that banks and ratings agencies, which penalize companies that carry too much debt, force them to use off-balance-sheet financing. Specifically, a company with a high debt-to-equity ratio may find that lenders restrict capital, increase rates, or add conditions to loan covenants, and that credit agencies lower their ratings, raising the cost of capital. Other CFOs add that banks require them to isolate risky projects or assets in an VIE to segregate bankruptcy risk.

The SEC rules are eliciting the same type of ire from financial executives. Michael Coke, CFO of AMB Property in San Francisco, explains that the commission will require a comprehensive explanation of an issuer's off-balance-sheet arrangements, as well as an overview of its aggregate contractual obligations, contingent liabilities, commitments in the management's discussion and analysis.

"Overkill," says Coke. Perhaps "overdisclosure" would be the word, if companies begin to pack the MD&A with every shred of material (and immaterial) information available. Says Coke, "It will turn into a big CYA exercise."

And the result? "The cost of capital is going up for smaller companies," charges Coke, who maintains that those companies won't be able to handle the extra costs associated with extensive reporting and certification requirements. Already Coke has witnessed a doubling of premiums for AMB's director's and officer's insurance, an increase of between 10 percent and 30 percent in audit fees, and increases in legal fees, audit committee fees, and internal accounting costs.

Bob Shepard adds that it's impossible to put everything on the balance sheet, and that off-balance-sheet financing can simply reflect a decision to appropriately account for a transaction that is immaterial to investors. He also asserts that the SEC doesn't need different rules to stop off-balance-sheet abuse — by his lights, "Enron accountants deliberately complicated the footnotes" and ignored the spirit of the existing rules. However, Shepard predicts that at least the near term, CFOs will err on the side of conservative accounting.

"Off-balance-sheet financing is not dead," reckons Bruce Bolander, an attorney in the New York office of Gibson, Dunn & Crutcher, "it's just getting a healthy dose of scrutiny." Bolander, formerly counsel to the Treasury Department and secretary of the Chrysler Corporation Loan Guarantee Board, insists that 90 percent of off-balance-sheet vehicles are plain vanilla securitizations, associated with mortgages, auto loans, credit-card and trade receivables, and energy and health-care plants.

"They're routine and operate efficiently without controversy," maintains Bolander, "but the fraud cases are giving routine transactions a black eye."