Exploring Off-Balance Sheet Accounting and Fraudulent Accounting Practices

Art Lightstone, October 2011
Off-Balance Sheet Entities

- Also known as:
  - conduits
  - special purpose vehicles (SPV)
  - special interest vehicles (SIV)

- Have been around for a long time, and used for *both* legitimate *and* illegitimate purposes.

- Stem from the basic notion that corporations are “legal entities” that are separate from their owners.
Off-Balance Sheet Accounting: How it Works

If an individual wants to protect his personal assets from a risky business venture, he can create a corporation. Naturally, that corporation must now report its financial position within its own set of financial statements.

According to both legal and accounting rules, the corporation is now a separate legal entity from the owner.
Off-Balance Sheet Accounting: How it Works

• As you know, the assets and debts of the owner are separate from the assets and debts of the corporation.

• So then... what about when a corporation decides to do the exact same thing that the original owner did? After all, the corporation is an individual in the eyes if the law.

Hey... I’ve got an idea!
Off-Balance Sheet Accounting: How it Works

- If a corporation wants to protect its assets from a risky venture, it too can create a corporation.

- These can be known as subsidiary firms, shell corporations, holding corporations.

- According to accounting regulations (GAAPs and IFRS), the subsidiary corporation is a separate legal entity from the owner as long as it is not fully “owned” or “controlled” by the parent corporation.

- The shell corporation must now report its financial position within its own set of financial statements.

- Only the cost of establishing the shell corporation will appear on the financial statements of the parent corporation. The details of the shell corporation will not appear on the financial statements of the parent corporation. They need only be mentioned in the footnotes of the financial statements.
Where do we draw the line?

• In general terms, an item should appear on the company's balance sheet if it is an asset or liability that the company owns or is legally responsible for.

• However, “unconsolidated” subsidiaries (which are not wholly owned by the parent) may be recorded off-balance sheet.

• Thus, the financial obligations of the unconsolidated subsidiaries may be recorded off the balance sheet of the parent corporation.
  • Such obligations were part of the accounting fraud at Enron.
Where do we draw the line?

- Uncertain assets or liabilities need not be recorded on the balance sheet either.
- Assets are “certain” if they meet the test of being *probable*, *measurable*, and *meaningful*.
- For example, a company that is being sued for damages would not include the potential legal liability on its balance sheet until a legal judgment against it is likely and the amount of the judgment can be estimated; if the amount at risk is small, it may not appear on the company's accounts until a judgment is rendered.
Off-Balance Sheet Entities

• Legitimate Purpose:
  • To separate riskier business activities from more secure business activities.
  • Example: An oil exploration company might separate out the exploration aspect of their operation (riskier, more speculative undertaking) from the drilling aspect of their operation (more secure, more lucrative).

• Problem: Financial rules do not require parent companies to include the accounts of SPVs on their financial statements. Parent companies just need to disclose information about SPVs in the “footnotes” of their financial statements.
Off-Balance Sheet Entities

- **Illegitimate Purpose:**
  - Because financial rules do not require parent companies to include the accounts of SPVs on their financial statements, parent companies can use SPVs to hide debt from the public (including banks, bond-rating agencies, and shareholders).
  - Enron used SPVs to commit outright fraud, which led to the biggest bankruptcy in US history.
  - Lehman Brothers used Repo 105, wherein they moved 50 billion of debt off of their balance sheet, making it appear that they were in good financial shape.
A legal application of off-balance sheet accounting: Operating Leases

• Under current accounting rules both in the United States (US GAAP) and internationally (IFRS), operating leases are off-balance-sheet financing.

• Operating leases involve the use of a SPV to hold an asset on behalf of a corporation and then lease that asset to the corporation.

• The asset and the associated debt are therefore held off of the parent corporation’s books.

• Operating leases are sometimes referred to as “synthetic” leases.

  • Definition of “Synthetic lease”: The creation by a parent company of a special purpose entity to which is given a certain property and which leases the same property back to the parent company. A synthetic lease allows the parent company to use the property for any purpose it wants while not recording it as an asset on its balance sheet. Instead, it is recorded as an expense.

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Off-Balance Sheet Accounting: Fact or Fiction?
Off-balance sheet entities and the current economic crisis

To understand how off-balance sheet entities contributed to the current economic crisis, we first need to understand a couple of financial concepts:

• securitization, and

• asset-backed commercial paper
Securitization

- Securitization is the financial practice of pooling various types of contractual debt such as residential mortgages, commercial mortgages, auto loans or credit card debt obligations and then selling this consolidated debt (often through SPVs) as bonds or other styles of securities to various investors.

- The principal and interest on the debt, underlying the security, is paid back to the various investors regularly.

- Using this method, debt originators (the original creditors to whom money is owed, such as banks or credit card companies) can issue loans or credit to almost anyone, and then quickly dump that debt onto unsuspecting investors who buy shares in the debt from an SPV (although an investment bank usually facilitates the sales of such shares).

- If the original debtors default on their debt (don’t pay their debts), then investors can’t seek any recourse through the debt originators or the investment bank, because the ownership of the debt actually resided with the SPV - not the originators of the debt or the investment bank.

Securitization in Banking

• Traditionally, banks lend to borrowers under tight lending standards and then keep loans on their balance sheets and retain credit risk (i.e. the risk that borrowers will default, IOW, not repay interest and principal as specified in the loan contract).

• In contrast, securitization enables banks to remove loans from balance sheets and transfer the credit risk associated with those loans.

• **Securitized debt** is represented off the balance sheet because securitization involves *selling* the loans to a third party. The loan “originator” (the original party that gave out the loan) and the “borrower” (the original party borrowing the money) being the first two parties.

• Banks disclose details of securitized assets *only* in notes to their financial statements.
The Banking Example:

- A bank may have substantial sums in off-balance sheet accounts, and the distinction between these accounts may not seem obvious.

- For example, when a bank has a customer who deposits $1 million in a regular bank deposit account, the bank has a $1 million liability.

- If the customer chooses to transfer the deposit to a money market mutual fund account sponsored by the same bank, the $1 million would *not* be a liability of the bank, but an amount held in trust for the client (formally as shares or units in a form of collective fund). If the funds are used to purchase stock, the stock is similarly not owned by the bank, and do not appear as an asset or liability of the bank.
Asset-Backed Commercial Paper

- **Asset-backed Commercial Paper** is an application of the concept of securitization to funding of trade receivables. Several originators wanting liquidity against their trade receivables sell these receivables to a conduit (i.e. SPV) which then issues commercial paper; that is, short term paper of typically 90 days to 180 days maturity corresponding to the present value of such receivables.

- On maturity, the originator is supposed to collect the receivables and pass them over to the holders of the paper through the conduit.

- At times, the conduit (SPV) is sponsored by a major bank which also provides liquidity support to the conduit to ensure timely redemption of the paper (i.e. make payments on a regular, reliable basis).
How can securitization convert sub-prime mortgages into AAA Asset-Backed Commercial Paper?

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<th>Asset-Backed Commercial Paper</th>
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<td>MBS</td>
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Mortgages → Mortgage-Backed Security → MBS → Asset-Backed Commercial Paper

(The first 8% of losses)
(The second 8% of losses)
(The third 8% of losses)
(The fourth 8% of losses)
(The last 76% of losses)
Who’s behind ABCP?

Some the notable administrators of ABCP in the US market are:


Note: Citibank had USD $960 Billion in off-balance sheet assets in 2010, which amounts to 6% of the GDP of the United States.
Fraudulent Transactions

• Fraudulent transactions refer to transactions that communicate circumstances that are materially different from the actual circumstances that gave rise to them.

• Fraudulent transactions result in misleading financial statements

• For example:
  • recording the entire future value of long-term lease contracts as current sales [ex. Xerox],
  • recording operating expenditures (expenses) as capital expenditures (assets) [ex. Worldcom],
  • recording a temporary exchange of assets for cash (repo) as a permanent sale [ex. Lehman Bros.],
  • recording personal expenses as business expenses [Parmalat]
Fraudulent Transactions Case Study: Lehman Bros.

- Lehman Brothers used an accounting move they called “Repo 105” to move 50 billion of short-term debt off of their balance sheet by re-classifying “Repurchase Agreement Debt” (liabilities) as “Sales” (revenue).
- A “repo” works like a pawn shop deal by temporarily trading assets (in this case, ABCP) for cash, and then swapping the cash and assets back a few days later.
- They would do this just before generating their financial statements.
- This made it appear that Lehman Brothers was in far better financial shape than it was.
- When the truth came out, the financial crisis was born.
- As a direct result of recent accounting frauds, the US Congress passed a tough new law called the Sarbanes-Oxley Act, 2002.
- This Act imposed stricter rules on auditors and made corporate directors criminally liable for lying about their accounts.
Lehman Brothers