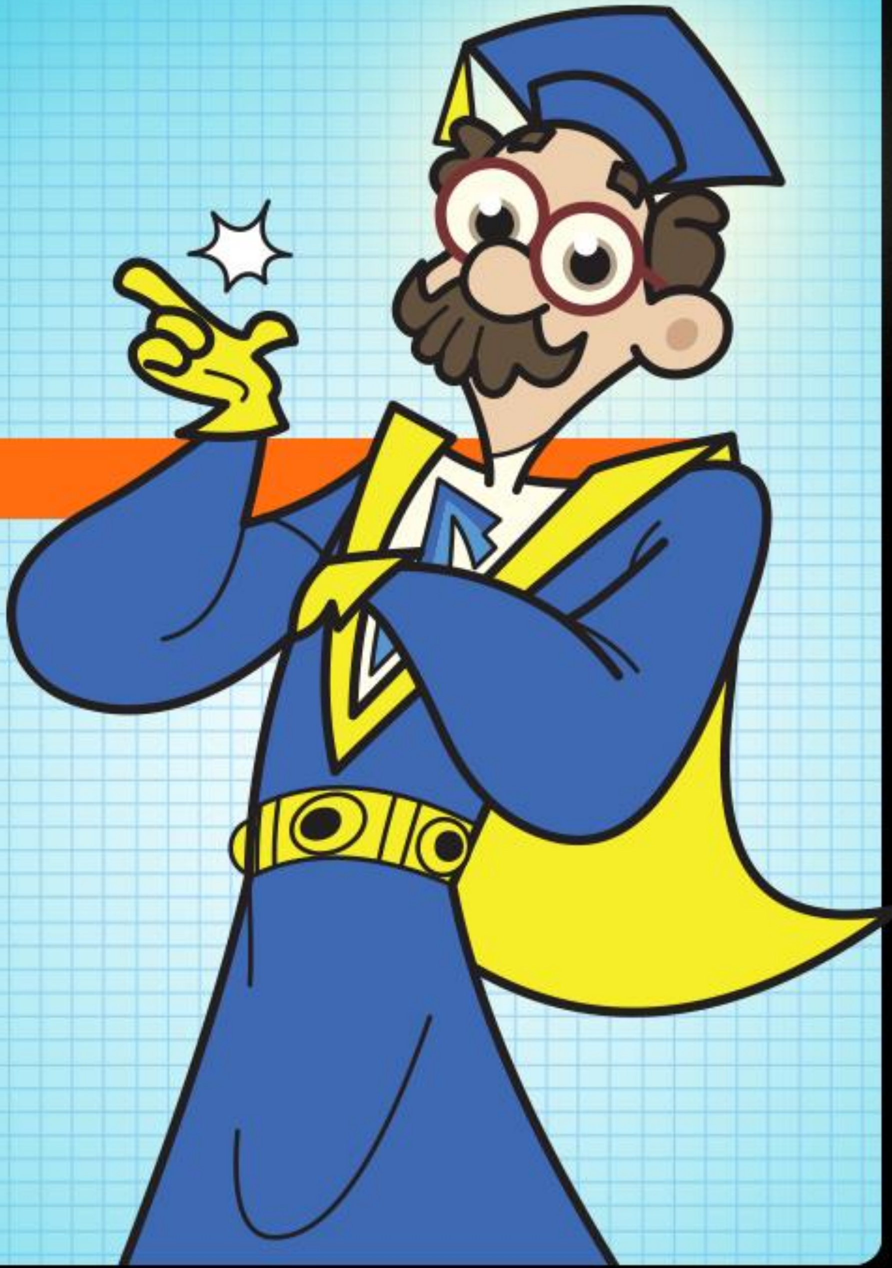
OFF-BALANCE SHEETS



Understanding

Off-Balance Sheets

– By Prof. *Simply* Simple™

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OFF-BALANCE SHEETS

- An Off-Balance Sheet (OBS) usually means an asset or debt or financing activity that is not reflecting on a company's balance sheet.
- In other words, it is a form of financing in which large capital expenditures are kept off a company's balance sheet through various classification methods.
- Companies will often use off-balance sheet financing to keep their debt to equity (D/E) ratios low, especially if the inclusion of a large expenditure would give them a negative debt to equity ratio.

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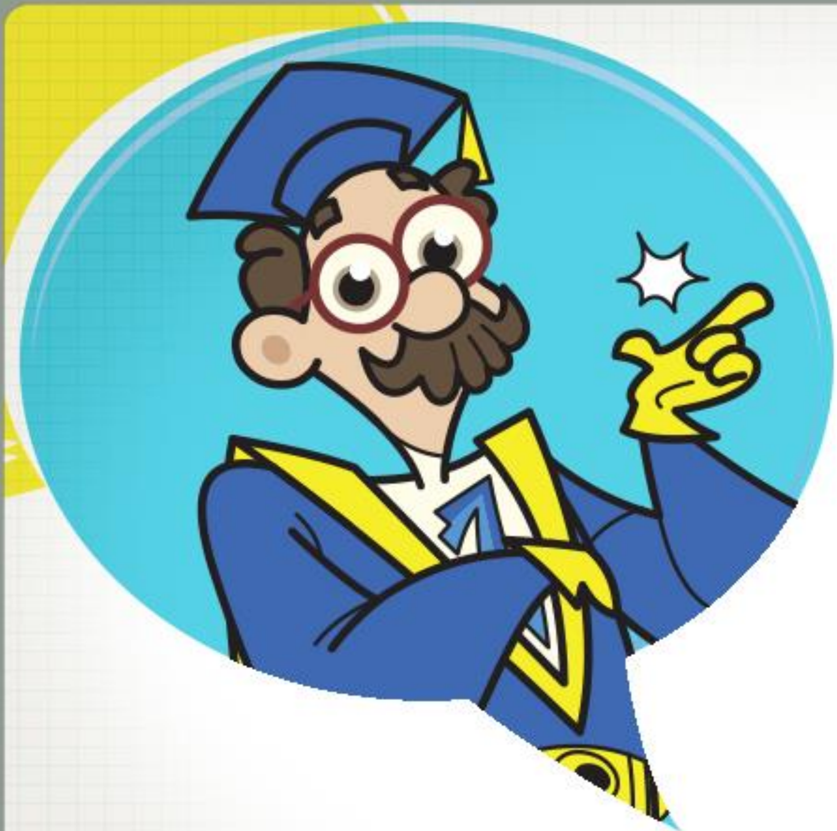

So what is the difference between an on and off balance sheet?

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- **The formal accounting distinction between on and off-balance sheet items can be quite detailed and will depend to some degree on management judgments.**
- **But in general terms, an item should appear on the company's balance sheet if it is an asset or liability formally owned by the company or if the company is legally responsible for it.**
- **Uncertain assets or liabilities must also meet tests of being *probable*, *measurable* and *meaningful*.**

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For Example…

- **Say company A has a subsidiary company B & it offloads all its risky investments in it.**
- **Now, any potential losses of the subsidiary company do not reflect in the books of records of the parent company.**
- **This helps A to appear financially more stable in the eyes of the public.**
- **But it also becomes responsible for any losses that arise in company B. This however is something the public doesn't know.**

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What company A does is that it

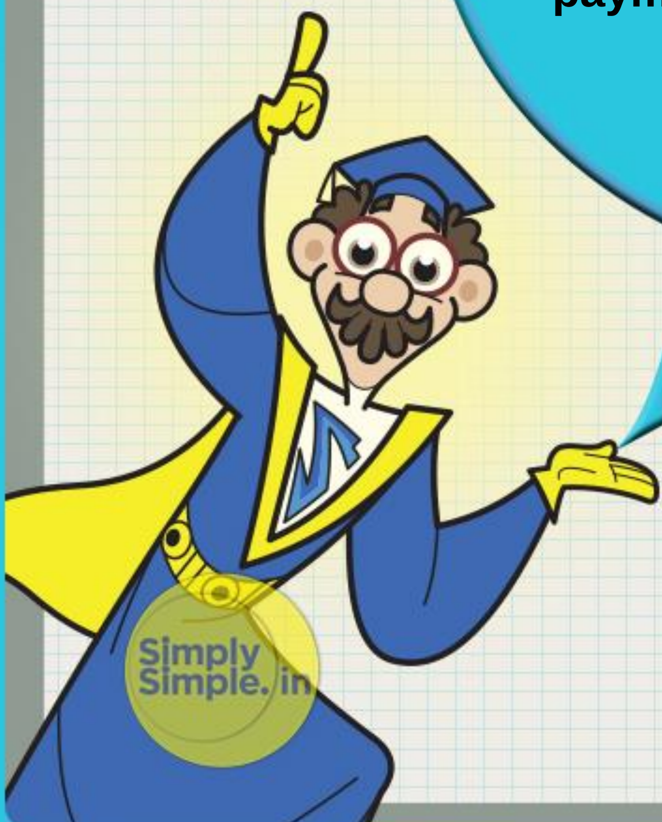
puts the risky ventures of its subsidiary

company B & any resulting

payment/expenses/losses out of its

balance sheet &

appears more healthy.



OFF-BALANCE SHEETS

Companies have used off-balance sheet entities responsibly and irresponsibly for some time.

These separate legal entities were permissible under tax laws so that companies could finance business ventures by transferring the risk of these ventures from the parent to the off-balance-sheet subsidiary.

OFF-BALANCE SHEETS

Now…

This was also helpful to investors who did not want to invest in these other ventures.

Since the Enron scandal, however, General Accepted Accounting Principles (GAAP) allow these items, whether justifiable or not, to be excluded from the parent's financial statements but usually they must be described in footnotes.

OFF-BALANCE SHEETS

Giving you another example…

- **We had discussed the concept of ‘Oil Bonds’ in one of my earlier lessons.**
- **Oil bonds are paid by the Govt. to oil companies to fund the subsidy on petroleum products.**
- **Now, a bond is a promise to pay at a later date.**
- **Thus, although the oil cos. are paying money upfront for purchases, they are being compensated by means of oil bonds which is a deferred payment.**

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Also…

- **Besides the oil companies' losses, the Govt. too has to pay up the money at the end of the stipulated time period which often could be a few years later**
- **Thus, what these bonds are doing is just postponing the losses, which have to be repaid some day.**
- **And somewhere, at some point in time, the promised doles met out earlier will also eat into the Govt's revenues, thus adding to the fiscal deficit.**
- **But here's the catch…**

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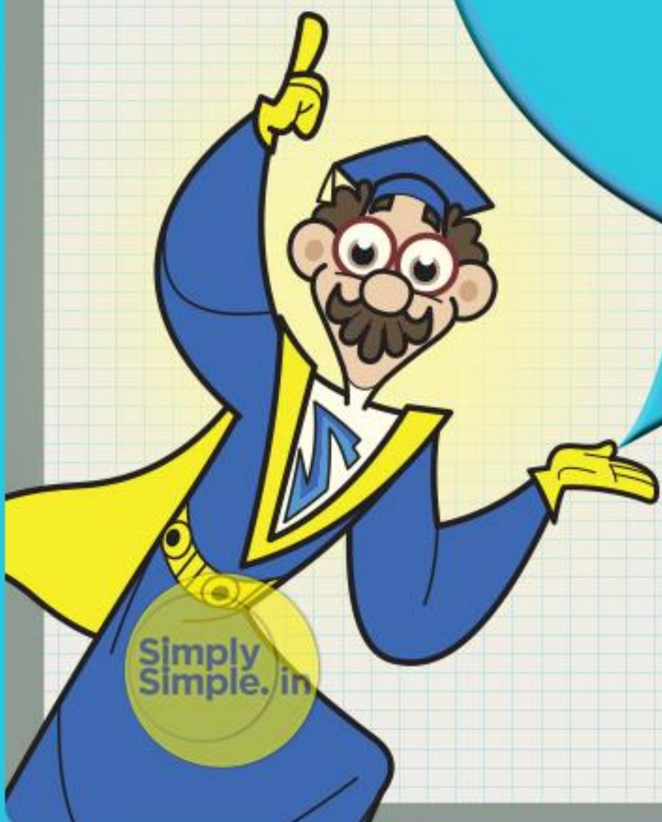

Did you know that the Govt. does NOT incorporate oil bonds in its balance sheets?

OFF-BALANCE SHEETS

- What this means is that while the Govt. is liable to pay oil companies at some point in time but this is not reflected in its books of accounts.

- *Simply* put, in contrast to loans, debt and equity; the oil bonds do not appear on the balance sheet for the current year as they are future liabilities.

- This makes the balance sheet appear healthier.

OFF-BALANCE SHEETS

To Sum Up

- **What: An Off Balance Sheet (OBS) usually means an asset or debt or financing activity that is not reflecting on a company's balance sheet.**
- **How: It was permissible under tax laws so that companies could finance business ventures by transferring the risk of these ventures from the parent to the off-balance-sheet subsidiary.**
- **Why: Tax laws allow these items to be excluded from the parent's financial statements but usually they must be described in footnotes.**

OFF-BALANCE SHEETS

Hope you have now understood the concept of Off-Balance Sheets

Thinking of Investment

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