Companies are typically evaluated by financial statement users on a number of dimensions: net profits, sales, total assets, etc. The outcome of these evaluations are frequently significant to the firm in that they determine to a large extent the ability of the company to generate future capital from outside sources. For example, access to borrowed funds from individual or institutional lenders is dependent, in part, upon existing debt levels within a firm. Not only do financial indicators, such as the gearing ratio, determine access to lenders but also the cost of borrowing once access has been attained. Hence, there exist significant reasons why a company might want to minimize the level of its reported borrowings. One approach to achieving this latter objective has become known as “off-balance sheet financing”.

Off-balance sheet financing refers to the acquisition of revenue producing assets in such a way as to avoid the related balance sheet disclosure of the cost of obtaining the use of these assets. A number of such financing techniques legitimately exist under current Australian accounting standards. An awareness of these financing methods is critical before a full appreciation of the financial stability of a company can be obtained. Hence, the purpose of this commentary is to highlight several of these methods and illustrate their use in the Australian business community. Three groups of off-balance sheet financing techniques are discussed: unconsolidated subsidiaries, joint ventures and associate companies, and executory contracts.

**UNCONSOLIDATED SUBSIDIARIES**

It is commonly believed that any time a firm obtains a majority ownership of the voting shares of another company the financial results of the subsidiary company must be consolidated with those of the parent. Unfortunately, there are very few absolutes in the practice of accounting, and this is no exception. Under existing accounting standards, the parent company may choose not to consolidate a subsidiary (even a wholly-owned one). The Ninth Schedule of the Companies Act provides for this exception so long as the company’s directors can provide good justification for the decision. Stock exchange listing requirements likewise provide for this exception; a listed company need not consolidate a subsidiary if approval is obtained from the exchange. A frequent explanation given for non-consolidation is that the parent and the subsidiary are significantly different operationally, for example as evidenced by variation in their earnings streams, such that consolidation may produce distorted and potentially misleading financial results.

A classic illustration of how an unconsolidated subsidiary can be used as a vehicle for off-balance financing by the parent is the manufacturing concern which has created a financing subsidiary to facilitate the sale of its products. Typically the subsidiary will borrow large sums of money, which the parent may guarantee, and which the subsidiary will utilize to buy the receivables of the parent (or provide financing directly to prospective buyers of the parent’s products). The net result is that the parent company ends up with the newly borrowed funds, but not the related debt, which remains on the unconsolidated subsidiary’s books.

For a closer look at the dramatic effect that a financing subsidiary can make, consider the case of International Harvester Australia Ltd. and its wholly-owned subsidiary, International Harvester Credit Corporation of Australia Ltd. The principal activity of I.H. Credit Corp. is to provide financing for the sale of new and used products manufactured or sold by I.H.A. Ltd., its dealers, and distributors.

An examination of I.H.A.’s consolidated accounts as of October 31, 1981, reveals current liabilities of $178 million, non-current liabilities of $15 million, and...
equity capital of $61 million. A preliminary analysis might suggest a debt-to-equity ratio of 3.21, but a careful reading of I.H.A.'s significant accounting policies reveals that the consolidated accounts do not include the accounts of I.H. Credit. The interested reader must look to the separate financial report of the subsidiary to obtain a true picture of the company's consolidated debt position. The 1981 I.H. Credit report reveals current liabilities (net of amounts owing to the parent company) of $108 million and net non-current liabilities of $89 million. Hence, I.H.A.'s debt-to-equity ratio is really as high as 6.5, more than twice the initial assessment.

It is important to note that International Harvester is not doing anything underhanded, nor will the use of this accounting convention result in a qualified auditor's opinion. Fortunately, the use of unconsolidated subsidiaries has not yet become widespread in Australia, unlike the situation in the U.S. Nevertheless, it is important for financial report users to understand that the practice is both permissible and currently used by some companies in Australia. As financial times become more straining and the cost of borrowing increases, the incidence of this practice can reasonably be expected to be on the uptrend. Unfortunately, the position of the accounting profession appears to be one which places the onus on financial statement users to be sufficiently sophisticated and informed to recognise the presence of such accounting practice.

JOINT VENTURES AND ASSOCIATED COMPANIES

Close cousins to the unconsolidated subsidiary are the joint venture and the associate company. Current accounting standards provide that where a majority interest in such investments is not attained, the investment should be accounted for under the cost or the equity method. Under either accounting method, the parent effectively reports only its investment in the joint venture or associate company (adjusted for share market changes or venture profits), and absolutely none of the venture or associate company debt, which may even be guaranteed by the parent.

A recent illustration of the joint venture and associate company approach is given by CSR's acquisition of Delhi Petroleum. Initially, CSR acquired nearly 100 percent of the voting shares of Delhi through a cash tender offer funded by a consortium of six international banks. Subsequently, CSR established a financing unit trust which acquired Delhi from CSR at cost (approximately $600 million) and assumed CSR's liability for the repayment of the acquisition financing. The trust was to be 50 per cent owned by CSR, with the other 50 per cent being owned by the lending institutions which agreed to provide long-term financing for the venture. By restricting its ownership interest to 50 per cent, CSR was able to employ joint venture/associate company accounting procedures and hence take the $600 million cost of financing the Delhi acquisition off-balance sheet (and consequently not upset its own gearing).

A closely related off-balance sheet technique involves the "layering" of ownership in associate companies. A classic illustration of this method is provided by Adelaide Steamship. Adstream, for example, directly owns a 44 per cent interest in David Jones, which in turn owns a 48 per cent interest in DJ's Properties. Adstream, however, also directly owns approximately 44 per cent of DJ's Properties, which in turn owns 40 per cent of Tooth, with Adstream itself directly owning another 40 per cent of Tooth. Under existing accounting standards, Adstream could undertake significant off-balance sheet borrowing through each of the above three firms in that its direct ownership never exceeds 50 per cent, at which point consolidated accounting procedures would presumably be utilised. However, as suggested above, even if the 50 per cent level is exceeded, Adstream could resort to the use of the unconsolidated subsidiary. Nevertheless, what is critical to recognise is that, regardless of the circumstances, the parent company can obtain access to borrowed funds without the requirement to disclose the debt instruments associated with the borrowed funds.

EXECUTORY CONTRACTS

Executory contracts refer to a broad group of contractual arrangements that provide for various types of future performance by the parties involved. Under this rubric falls a variety of asset financing methods such as leasing agreements, floor plan arrangements, and long-term purchase and supply contracts. The common element of all executory contracts relates to the fact that in each case, access to a given asset (or group of assets) is contracted for over an extended period of time. Under existing accounting standards, future obligations under such contracts, even if non-cancellable, need not be currently reported since access to the asset will not occur until some future date (i.e., liabilities need only be reported for the value of assets currently received).

Exemplary of this situation is the ordinary lease agreement. Current accounting practice requires that if an asset is purchased outright using a debt
instrument, both the asset and the related liability must be disclosed on the face of the company’s balance sheet. Many companies today, however, are resorting to asset leasing rather than direct purchase in part because of the high cost of borrowing and availability of funds, but also because under current lease accounting the company need not report the future lease obligation as a liability. Not only does this help the traditional gearing ratios, but in many cases will also extend the company’s ability to obtain external financing.

Consider, for example, the case of ICI Australia Ltd. In 1980, ICI announced in the financial press the formation of a joint venture, Olefines Pty. Ltd., with the Australian Mutual Provident Society to finance the development of an ethylene plant in Sydney. The arrangement provided that once construction was completed, Olefines would lease the plant to ICI for a period of seventeen years. A footnote in the 1980 financial statements of ICI reveals the magnitude of the lease obligation: $4.9 million in the next year and $499 million over the remaining life of the lease. Cutting through the veneer of the joint venture and the non-cancellable lease arrangement, it becomes clear that the underlying transaction merely involves the off-balance sheet acquisition of an ethylene plant by ICI. Excluding the lease obligation, ICI’s debt-to-equity ratio for 1980 is a modest 81 per cent. Inclusion of these lease obligations, however, nearly doubles the ratio (i.e., 156 per cent).

Another popular form of the executory contract is the floor plan/deferred credit method. Under this approach, products are sold by a manufacturer or importer to a finance subsidiary, which then allows the manufacturer’s dealers and distributors to display and (hopefully) sell the product. The arrangement can be likened to stock on consignment except that in this instance, a holding charge is paid by the “consignee” to the finance subsidiary until the goods are sold, and the distributor rarely has the right of return. Note that the manufacturer may be able to recognise a profit when the “sale” to the finance subsidiary occurs (assuming non-consolidation), and that the dealer or distributor avoids recognition of the non-cancellable obligation since good title will not pass until the product is sold.

An illustration of this methodology is provided by the York Motors Holdings Ltd. In 1979, York reported a debt-to-equity ratio of 96 per cent, up from 64 per cent in the previous year. In the period ended November 30, 1980, the company’s stocks were reduced by over $6 million. This decrease was attributable to several factors: a conscious decision by management to reduce stock levels ($3.8 million) and the adoption of a deferred credit/floor plan arrangement ($2.3 million). Thus, the off-balance sheet financing enabled York to retain access to the stock for sale purposes and yet also show an improved (56 per cent) debt-to-equity position.

A final form of the executory contract that has achieved some popularity in Australia is the long-term purchase or supply contract. In a recent case, for example, a leading Australian bread producer, faced with increasing storage requirements, was offered a grain silo by one of its major suppliers. To finance the acquisition off-balance sheet, the bread producer entered into a long-term, non-cancellable supply contract with the grain merchant in which the storage facility would be paid for via a premium on future grain purchases. Since long-term purchase contracts are executory in nature, no future purchase obligations were required to be disclosed and the current period payments were treated as items on the profit and loss statement.

Purchase and supply contracts have also been used to secure financing for new ventures. A manufacturing company recently obtained financing for a new plant and equipment for another company by agreeing to purchase all of the production of the company under a long-term “take or pay” contract. Not surprisingly, the new company had been created by the manufacturer and both companies shared a common set of shareholders. Under take-or-pay contracts, the “parent” company agrees to make payments to the newly formed supplier, regardless of whether or not production is forthcoming. In effect, the original manufacturer obtained access to new productive capacity off-balance sheet by guaranteeing the loan of the new company through a non-cancellable purchase agreement. Because such agreements go effectively unreported, the company would not appear to have altered its own gearing.

**COMMENTARY**

The use of off-balance sheet financing is rapidly becoming the norm rather than the exception in the Australian business community. It is, in effect, a fact of life that financial statement users must recognise. Further, it is unreasonable to expect rapid changes in existing accounting standards to deal with these methods of concealing financial obligations. Instead, financial statement users must become acquainted with these methods and recognise that they may have a dramatic impact on the true financial condition of a company.