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“Off-Balance Sheet” Debts Cause Concern

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Is the company you own stock in carrying a lot more debt than what's shown on its balance sheet?

After Enron unraveled, a great deal of fuss was directed at “off-balance sheet” debts hidden from plain view of investors, prompting the Securities and Exchange Commission to require more disclosure of these liabilities.

Though most examples of off-balance sheet debt are far removed from the shadowy underworld of Enron's books, there are nonetheless billions of dollars in real financial liabilities which are not immediately apparent in the financial reports of the nation's public companies.

Among 120 of the major companies in the Standard & Poor's 500-stock index, long-term debt rose by a median of about 30 percent when operating leases and other financing arrangements were added to the balance sheet, according to a study of annual reports by RateFinancials Inc.

FedEx Corp., for example, filed its annual report two weeks ago with a balance sheet showing liabilities totaling $11.1 billion, consisting of $4.7 billion in debts requiring payment over the next year and $6.4 billion in longer-term loans and obligations.

That's the balance sheet. A more in-depth examination of the 156-page report shows that FedEx actually has legally binding obligations which in present value may total somewhere between $11 billion and $14 billion in additional debt.

In other words, the company's actual liabilities may be more than double the amount which appears on the balance sheet.

But to reach that conclusion requires patient reading and a series of calculations which, by now, are fairly routine and intuitive for professionals - and anything but simple or instinctive for most individual investors.

Under current accounting practices, FedEx's presentation of the facts appears perfectly acceptable. And the biggest chunk of the off-balance sheet debt, operating leases, is quite common across multiple industries.

“Ideally, yes, all leases could be put on the balance sheet,” said Itzhak Sharav, accounting professor at Columbia Business School, noting that it took heavy compromise to get the rules tightened to the current standard. “But the disclosure is there, so I don't see this as a very big problem”

Still, a question remains: Should information as basic as what a company owes be accessible to the untrained eye, or should investors be forced to depend on analysts and fund managers as their trusted filter of the truth.

Though it's unfair to paint with too broad a brush after the analyst and mutual fund scandals, it would be nice to think that any individual investors who'd like to vet a company's financials on their own might be able to do so. Instead, it takes a rather intrepid soul to go it solo.

That's unfortunate because, among the various financial tables available to investors, the balance sheet is pretty often seems to be the easiest to read and comprehend.

Under the heading of “assets,” for example, there are generally straightforward terms like cash, inventory, accounts receivable, property and equipment. On the liability side, there's short-term debts like accounts payable, long-term loans and pension obligations.

Some entries can be more cryptic, like shareholder's equity. But on the whole, it seems easy to get the basic point. Except it's not, since not all the pertinent information is reflected on the balance sheet.

An investor needs to know to go digging through the report, and any amateur brave enough to do so may not recognize the significance of footnotes and other sections, or that many professionals crunch the numbers in those disclosures and then adjust the balance sheet accordingly.

In the case of FedEx, a reader would need to find a separate section of the annual report entitled “CONTRACTUAL CASH OBLIGATIONS,” where under a sub-heading called “Other cash obligations not reflected in Balance Sheet,” the company discloses what on the surface adds up to another $18.4 billion worth of future debt payments relating to operating leases and unconditional purchase obligations.

However, it's not as nearly simple as adding that number to the liabilities on the balance sheet to arrive at a total. Because money owed years down the road isn't an immediate burden like money owed tomorrow, the future obligations need to be “discounted” to remove the interest portion of the future payments.

But to do this, one needs to make varying assumptions as to the number of years over which the debts need be repaid, as well as what interest rate the company is paying.

Still, because the footnotes and other disclosures ensure that some version of the truth is attainable, the pros don't see this topic as a very big deal – particularly compared with issues such as the battle to get companies to record an expense for stock options given to employees.

“Leases have always been contentious,” said Jack Ciesielski, editor of the Analyst's Accounting Observer newsletter. “While it's not on their current agenda, I would expect them to jointly overhaul lease accounting (with the international standards body). I wouldn't expect it until after each one clears up its own respective political brush fire.”

Until then, investors will need to keep jumping through hoops to arrive at the truth.