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Drawing the line: The political economy of off-balance sheet financing

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Scholars in the social studies of finance and accounting (Callon 1998a, b, Callon/Muniesa 2005, Çalışkan/Callon 2010, Mennicken 2002, Volmer et al. 2009) have pointed to the importance of boundary drawing to enable calculation, forming the precondition of economic activities. Insisting that all calculation begins with “distinctions between things or states of the world” (Callon/Muniesa 2005: 1231), scholars in this area have focused on the disentangling and framing of activities and entities (Callon 1998a) that create spaces of commensurability, thereby facilitating exchange. Calculative devices, such as accounting (Callon 1998a: 29) disentangle goods from their environment, which enables pricing. By clarifying ex ante in these situations what needs to be taken into account in the calculation, framing is understood to create a space “which brings together the different parties and allows them to harmonize their desires” and thus to come to a mutually agreed exchange (Callon 1998b: 250).

While these are very important theoretical advances in economic sociology, the focus on the facilitating character of metric systems of valuation for exchange has led to a neglect of the political economy which resides in the moments of boundary drawing itself. While Callon focused on framing as a necessary precondition of exchange (1998a), he largely ignored the distributive consequences of these boundaries and the contestations it provokes (but s. Callon 1998b: 260-264 on the measurement of negative externalities). As we will show for the case of firms, the act of boundary drawing is a contested, political act. Demarcating boundaries of firms and their activities is a heated battleground due to its distributive consequences, be it in terms of taxation, costs of credit or the value of shares (Callahan et al. 2013), all of which are related to the recording of assets and liabilities on balance sheets. The application of financial accounting rules produces financial ratios (such as equity over liabilities) that function as a central regulative device in financialized capitalism (Froud et al. 2006) as it structures firms’ relationships to the state (taxation)1, creditors (price of borrowing, Kalthoff 2007) and shareholders (price of shares). Financial accounting numbers thus have a direct impact on the viability of the firm, as the cost of credit impacts profitability and share prices partially determine the vulnerability for takeovers (Froud et al. 2006).

Due to these implications, corporate actors, whose activities are being measured by accounting rules engage in reactive behaviour (Espeland/Sauder 2007) and seek to game the numbers that represent their size and activity to influence these distributional conflicts to their advantage. This implies that firm boundaries are not only influenced by simple transaction costs (Coase 1937), but instead are drawn to maximize exposure to gains and minimize exposure to potential losses (Robé 2011). Firm behaviour in this respect exemplifies the contention of historical institutionalists that “the typical rule taker that capitalist institutions must reckon with as the normal case is a rule bender: She reads rules entrepreneurially, untiringly looking for ways of twisting them in her favour.” (Streeck 2011: 146, italics in the original, also Streeck/Thelen 2005; Mahoney/Thelen 2010).

This conflict, inherent in the application of accounting rules plays out in the social relationships between the accountants, lawyers and regulatory advisors hired by firms to optimize accounting decisions and auditors of these firms who verify the correct application of these rules. The dialogues of these agents are shaped by the general properties of rules, which are by definition over- or under-inclusive, indeterminate and therefore subject to interpretation (Black 1997: 10; Garfinkel 1991). Market actors and their legal consultants exploit this feature of accounting rules which do not predetermine the classification decisions of accountants on the ground (MacKenzie 2009; Power 2012), coming up with constructs that only partially fit the paradigm case envisioned in the rules (Black 1997). In this way, agents reflexively interact with these rules through “regulatory arbitrage” (Fleischer 2010: 229): perfectly legal planning techniques that exploit the gap be-
The measurement of economic activity through accounting rules thereby leads to a change in economic activity itself, which we may call a performative effect of accounting (Froud et al. 2006; also Mennicken 2002). This reflexive feedback loop between business activity and accounting rules is driven by the conflict of interest between those preparing financial statements, accountants of firms and those using them, financial analysts (Borio/Tsatsaronis 2005: 12; Dye et al. 2014). This external mode of observation is the foundation for the creative compliance with accounting rules by firms, as accountants exploit the increase in the supply of information that credit and equity analysts have to process in recent decades. As Luhmann (1991) has pointed out, the increasing complexity in financial markets leads to attempts at simplification by external observers (p. 188 – 189; also Esposito 2011). Given the growing obscurity of financial reports, which is structurally promoted as annexes are ever-growing and difficult to evaluate in their information content (s. Hoffmann/ Luedenbach 2007), there is an increasing tendency among financial analysts to reduce this complexity to easily graspable ratios. Financial ratios, such as the debt to equity ratio are such means of simplification that analysts employ, as we will explain below.

The tyranny of financial ratios and systemic balance sheet manipulations

The potential ignorance of credit analysts regarding the possibilities to manipulate financial ratios in accounting due to information overload makes attempts by single firms to push assets and debt off-balance sheet systemically, as the comparison of firms, according to which share prices and costs of debt are determined, are partially built on these financial statements. These performative aspects have a systemic impact on accounting policies, as those companies which are not pushing the interpretive margins of accounting rules will be treated comparatively worse in financial markets. As financial accounting numbers force conglomerates into a relentless comparison in terms of their valuation, such acts of regulatory arbitrage give certain conglomerates a cost advantage by presenting a better image than the economic substance of activities would justify. As these acts of regulatory arbitrage are legal, they become systemic once the practice spreads. This threatens the function of accounting to represent reality, as becomes clear in the following remarks by the Senior accounting standard setter mentioned above:

“So they confound the image with the reality, and if you consolidate everything you need to consolidate, your balance sheet is worse, looks worse and you look like a bad manager, and this is the one who has done the things correctly. …if having accounting that does not reflect the reality is an advantage,
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that evidently forces not to represent reality.” (Interview Paris 01/2011, translation M.T., emphasis added)

This trend to not represent reality in accounting leads to attempts by management to push assets and liabilities off-balance. The same standard setter reflects,

“They try to overcome regulation, which is especially impregnating, because there is a tyranny of financial ratios. And you do whatever it takes to have good financial ratios. … It is a pity to see that because the enterprises are pushed to make mistakes in order to respect their ratios. So they say, listen I cannot put that on my balance sheet, that will add debt and so it will deteriorate my financial ratios…”

In the following we will focus on these techniques to hide debt related to the delineation of conglomerates, the predominant form in which economic activity is organized today.

Conglomerates are produced through a performative speech act as accountants delineate the borders of a “fictional jurisdictional unit”, which does not exist in legal terms (s. Claussen/Scherrer 2011: 1021, translation M.T.). In legal terms, conglomerates are a network of corporations but in economic terms they are one business unit. Accounting rules, as opposed to corporate law have to determine if the relationship between corporations equals a conglomerate, i.e. if there is complete control exerted by the parent company over subsidiaries or if they are simply cooperating as business partners.

The performative accounting act of delineating a conglomerate and the shifting of risk to Special Purpose Entities

Auditors seek to provide financial market participants a “true and fair view” of the business activities and risk exposures of conglomerates (Walton 2008) by merging the different companies judged to be controlled by one parent company into one consolidated balance sheet. The drawing of the boundary of the conglomerate, that is determining which entities are to be taken into account in forming the conglomerate (what is known as “the perimeter problem” in accounting studies) is where the fight between auditors and the audited firm takes place. If the audited (parent) firm can manage, in the exercise of categorization, to exclude disadvantageous corporations and their assets and liabilities which worsen the equity ratio, that firm has gained great leverage over the process by which financial analysts calculate financial ratios.

It is at this point that Special Purpose Entities (SPE), shell companies into which conglomerates are placing assets and liabilities, come into play. Exploiting the indeterminacy of accounting rules, firms seek to structure the relationship with the SPE as to be outside the boundary of the conglomerate. In this way, firms seek to keep assets and liabilities outside the purview of creditors, shareholders as well as regulators, while benefitting from their use.

The indeterminacy of the conglomerate’s boundaries and the use of special purpose entities to exploit it came into the spotlight during the recent financial crisis. Many banking conglomerates had optimized the conglomerate’s official demarcation, keeping subsidiaries that held assets worth hundreds of billions of dollars off the balance sheet (Gorton 2010; Milne 2009). But the use of special purpose entities for the purpose of balance sheet reduction is in no way limited to banks alone. A legitimate use is to finance construction projects and other large projects, separating the risks of those projects from the company at large. Asset-partitioning in this way allows for cheaper financing (Hansmann/Kraakman 2000). On the other hand, financial advisors utilize the off-balance-sheet effect for lease contracts. They do this to sell their clients a possibility to benefit from the economic ownership of assets while keeping them off their balance sheet.

Leasing

Leasing combines elements of an on-balance-sheet, debt financed purchase (the buyer becomes the owner of an item) and of an off-balance-sheet rent (the property in the item remains with the renter). The ownership in an item depends on the question which of these two features predominates in a specific case. Financial engineers draw and adjust the delineation between these categories reflexively in order to create the desired off-balance-sheet effect for the lessee, thus redefining these categories continuously. As Pottage (2004: 3) puts it, “the question […] is not how to fit entities into the ‘right’ category, but to explore the emergence and deployment of the category itself”.

A lease contract requires two parties, a lessee and a lessor. The lessee rents an asset from the lessor and pays a fee for it (Peters/Schmid-Burgk 2007: 11). The accounting of lease agreements under International Financial Reporting Standards IFRS3 follows an “all-or-nothing” approach which
distinguishes between a finance lease and an operate lease. In case of a finance lease ("all"), the lessee shall recognize the lease, valued at fair or present value, and a corresponding liability. For example, a firm leases an assembly line over 8 years (the major part of its economic life) and is committed to purchase the machine by the end of the lease term. Therefore, the lessee carries the price risk incidental to the item (similar to a purchase on credit). An operate lease ("nothing"), on the other hand, provides an off-balance-sheet effect for the lessee (Fülbier 2012: 101; International Accounting Standard [IAS] 17.20) because the lessor mainly bears the risk and has to recognize the item. For example, the lessee leases a car over one year, including a (not mandatory) purchase option and the depreciations and servicing costs are carried by the lessor4. At the end of the lease term the lessee can easily decide to reject the option and the lessor must organize the resale of a used car. In substance liabilities incurred through operate leases, only appear in the annex of the financial statement (IAS 17.35), thus, often escape the attention of financial analysts and do not affect their decision-making anymore. This also holds for credit analysts of banks, as was explained by a German accounting professor analysing the financing models of German small and medium-sized enterprises (SMEs):

"Many German firms have a high degree of external financing and if this is part of your business model, then leasing is a very good idea. Normally, this should not play any role regarding the decision to grant credit or not, as credit analysts are asked to also look into miscellaneous liabilities. But the problem is that many addresses only look at the income statements and the balances, they don't look into the annex. They are fixated on the financial ratios.” (Interview Wuppertal 06/2011, translation M.T.)

Lease agreements and special purpose entities

The vast majority of all lease contracts are directly concluded between lessors and lessees but some particular forms, such as Sale-and-Leaseback transactions (hereinafter SLBs) or synthetic leases5, usually involve Special Purpose Entities, their use being also strongly linked to issues of taxation. In a SLB-transaction the lessee sells an owned item and, simultaneously, leases it back over a period of time. If the SLB is designed as an operate lease, the lessee can continue to use the item without restrictions, releasing capital which otherwise would have been bound by a fixed asset (the item that has now been sold and leased back), and keeps the accruing liability (the lease) off-balance-sheet. A special feature of SLB transactions is that the asset is not directly leased back from a lessor but from a Special Purpose Entity, usually financed by a bank6 and jointly founded by the lessee as well as by the structuring lessor. The lessee possesses a renewable repurchase option to the SPE (Helaba [Landesbank Hessen-Thüringen] 2010; PwC 2008: 29; Streckenbach 2006: 49) that effectively ensures the property in the item for the lessee without exerting direct control7 over it. In so doing, the lessee relates the classification of the SLB (operate or finance lease?) to the question of consolidation of subsidiaries according to the accounting standard IFRS 10. In case of a German lessee, the SPE has mostly the legal form of a GmbH & Co. KG (Helaba 2010: 3; Fahrholz 1998: 146), which allows an asynchronous entanglement8 between both contract parties regarding shares and control of the SPE. Thereby, the lessee neither meets the prerequisites of consolidation of the SPE nor the criteria of a finance lease, thus, the Special Purpose Entity is consolidated by the lessor or by the bank and provides an off-balance-sheet for the lessee.

One can argue that synthetic leases are the “point of culmination” of the issue of boundary drawing and reflexivity. This financial instrument stretches the boundaries of property and non-property, of ownership and non-ownership, assets and non-assets, and the definition of conglomerate itself, to their limits by linking the respective manifestation to the addressees of the conglomerate’s financial statement.

The structuring of a synthetic lease is even more complex than a SLB transaction but follows a similar logic and blurs ownership of the SPE. A synthetic lease is structured to be an operate lease for purposes of financial reporting, whereas being treated as a finance lease for national tax law. By financing an asset through a synthetic lease, the lessee pursues the goal to keep the lease off-balance-sheet in its financial statement while using the possibility to depreciate the asset and to deduct the interest expenses9 of the SPE (Weidner 2000: 447) in order to reduce the lessee’s tax payments. Thus, the lessee is at the same time the owner of the SPE (for tax returns) and is not the owner of the SPE (in particular, for credit analysts and shareholders).

Synthetic leases are a “high stakes gamble in the game of form over substance” (Weidner 2000: 448) because they benefit from the sharp quantitative provisions of IFRS10 and German-GAAP. With those structures the lessee “cannot be sure whether it is approved by the state tax authorities (Interview 04/2014, Frankfurt) because, in the context
of a single transaction, dealt as one package, the question of recognition is answered differently.

The issue of recognition of both SLB transactions and, in particular, synthetic leases is subject of a bargaining process between the structuring lessor, the lessee and their auditors.

An auditor, describing the structuring process of complex off-balance-sheet leases constructions states:

“Well, insofar it is often a combined activity of several auditors. So, it usually starts like this, that the auditor of the customer [lessee] is asked first and then, when you are relatively sure [we] formulate [the contract] and then, you go again to the auditor, to show him [the lease contract] beforehand. And then, you have possibilities to point out what could be changed, where are needs for interpretations [...and this is [the moment] where you can usually intervene in time.” (Interview Frankfurt, 11/2013, translations and amendments J.F.)

Or as another auditor puts it, “this is an iterative process that goes back and forth” (Interview Frankfurt 06/2014, translation J.F.).

Balance sheet manipulations by banks pre-crisis

In the case of banks, the use of Special Purpose Entities to place assets off-balance sheet is motivated by core capital requirements which are applied to consolidated balance sheets of banking conglomerates (Acharya et al. 2009). As these core capital charges limit the leverage of banking conglomerates (that is the amount of capital they can borrow to finance their operations) and hence their potential profitability, banks attempt to place assets off-balance sheet in legal form while maintaining economic exposure to the risks and rewards of that entity. In the case of the ABCP market, they set up SPEs into which they placed highly-rated assets (e.g. Collateralized Debt Obligations, CDOs), which were refinanced with short-term Asset-Backed Commercial Papers (ABCP), securities with a maturity of less than one year and usually less than 90 days, posing refinancing risks due to the maturity mismatch. Through these techniques, Bank Holding Corporations were able to expose themselves to more risk than they officially recorded in their balance sheet, gaining economic exposure to these assets but refusing to account for the risks they posed. The orphaning of credits and their risks into the balance sheets of Special Purpose Entities meant that credit risk was building up in the system to a much larger degree than preventive measures taken to deal with the possibility of the actualization of these risks. Instead of distributing the risks into financial markets, this form of securitization concentrated risks off the balance sheet of banks, returning onto the balance sheets of banks once the assets in the SPE deteriorated.

The contractual structure between the investors, the special purpose entity and the sponsoring bank guaranteed that the bank would absorb the majority of rewards (revenues) emanating from the assets held in the SPE, but would also be exposed to the majority of risks. Banking conglomerates did not need to account for these risks via capital charges, regulatory requirements to have a certain extent of equity to deal with potential risks, if they could avoid consolidation of the SPE. At the same time, they earned fee income for the risk exposure through the services they provided to the SPE, thereby improving their financial ratios and their evaluation in financial markets. The relationship between SPEs and banking conglomerates was crafted to avoid the possibility of consolidation on the balance sheet of the bank, transforming the special purpose entity into an “orphan company” (see PwC 2005: 36).

To ensure that the SPE was not consolidated as a subsidiary required the structuring of the relationship between banks and SPEs counter to the accounting standards. Before 1998 in the US and Europe, the rules for conglomerates maintained that a company needs to consolidate a subsidiary company in which it holds the majority of shares and/or controls its business strategy. The interpretation of then actual accounting norms required that the control of the business had to be visible in the daily operation of the firm. Avoiding indicators of control in legal form, while maintaining control in economic substance led banks to shift control into the contractual realm. With the help of contracts all relevant actions by the SPE were pre-specified, putting the SPE on a contractual “auto-pilot.” These “auto-pilot mechanisms” specified that SPEs could not sell or buy assets on their own but that instead the investment advisor (the bank) made the investment decision (these are called service level agreements), for which the SPE would have to pay a fee. Furthermore, banks usually held no shares in the SPEs nor provided any other capital for them to maintain their non-controlling status which allowed the SPE to be off-balance sheet. This resulted in the SPEs having only minimal equity (own funds), which meant that these shell companies had no capacity to deal with a deterioration of the formerly highly-rated but now toxic assets on their own balance.
sheets. When the SPE’s assets started to deteriorate, investors refused to buy the ABCP from the SPE.

Instead, the sponsoring bank had guaranteed that in case there was a problem with the market refinancing, it would buy the newly issued the Asset-Backed Commercial Papers. This contractual arrangement called a liquidity facility, which was described even at the time by some as collusion between banks and investors (Gorton/Souleles 2006) made Asset-Backed Commercial Paper a technique of “securitization without credit-risk transfer” (Acharya et al. 2009).

The cycle of rules and rule-evasion in off-balance sheet financing

The practices of off-balance sheet financing described above contradict the goals of accounting standard-setters to generate a “true and fair view” of the firm. Standard setters in the International Accounting Standard Council, alarmed by auditors about this abuse of accounting rules, issued a new interpretation (SIC 12) already in 1998 which placed economic substance over legal form when making the decision whether to consolidate SPEs into the balance sheet of banks. Auditors were asked to focus on the firm that was bearing the majority of risks and rewards with relation to the SPE to determine consolidation. In this way, the standard-setters of the IASC11 sought to keep the negotiating situation between auditors and audited open and rather undefined. They refused to unambiguously specify the calculative procedures to disentangle the conglomerate from its environment12, instead granting the final say to the professional judgment of the auditor. Based on indicators (who holds the majority of risk and rewards with respect to an asset/ a special purpose entity) and principles (economic substance over legal form), the final decision-making resides with the auditor. As a consequence, banks restructured their contractual risk and reward exposure to the SPE by adding third parties that took just sufficient risk to refute the presumption that the bank was bearing the majority of risk and rewards (Thiemann 2012). This restructuring and the continued possibility for off-balance sheet SPEs points to the cycle of rules and rule-evasion in off-balance sheet financing.

This cycle is best described by an experienced auditor and accounting professor, when commenting on the increasing use of SPEs in the 1990s:

“It is not a new thing. It is just that the rules change over time. So the companies want to find a way to keep financing off-
"When you issue a pronouncement, people will look at it, and they will revise their strategies, ... so to some extent you moved the point along the spectrum ... you might discover that you have an awful lot of people spending an awful lot of time and awful lot of money to stay on one side of the line or the other and I think that is inevitable, ...and if you go to principles that is terrific but you still are going to have a judgement and a grey zone, so neither is the perfect solution." (Interview London 02/2011, emphasis added)

In this quote, the standard-setter acknowledges the power of those seeking to structure their deals such that they "stay on one side of the line", a force which you cannot control, given that you "still are going to have a judgment and a grey zone" in which those structuring will place their deals. A corporate lawyer, thinking about the new standard IFRS 10 which came into force in 2013 and seeks to limit the use of off-balance sheet special purpose entities further is also sceptical about the possibility to limit such activity once and for all:

"Is this the be-all and end-all? The IFRS 10, it is new right now, where even that one is not the wisdoms last conclusion, so I am just afraid that the problematic of special purpose entities is very difficult to get a grasp on, independent of the rule element you use." (Interview Cologne 11/2011, translation M.T.)

Why is an ultimate rule ending unruly off-balance sheet activity impossible? Because the structures of SPEs are determined in response to the rules which are seeking to capture them on the balance sheet. This dialectical relationship between SPEs and their rules means that one can only temporarily force SPEs on the balance sheet, until those structuring have found a new way to escape. Still, principles-based standards might be the best way for dealing with the problem, as is clarified by a senior auditor in a technical department of an auditing network in Germany:

"No, the problem is not solved, there you are totally right, but ... this is a process...we cannot write a handbook called treatment of SPEs where we then present the 1500 different models and then you look there for everything..., but because we don't want something like that ... we make a broad standard and that leaves space for discretion." (Interview Duesseldorf 02/2011, translation M.T.)

As this quote clarifies, discretion placed with auditors seems to be the best option to deal with the indeterminacy of the boundaries of the firm in a world in which this indeterminacy cannot be fixed by the rules themselves.

Conclusion

Based on the example of off-balance sheet financing, this essay has sought to demonstrate the political economy inherent in acts of boundary drawing. It has shown that corporations, exploiting the inherent indeterminacy of rules to predetermine decisions by auditors (MacKenzie 2009) employ off-balance sheet techniques to avoid the recording of assets and liabilities. These acts of regulatory arbitrage offer a temporary possibility for corporations to optimize their balance sheets and to avoid negative consequences in terms of taxation or costs of credit. Doing so, they exploit the incongruity between the economic substance of the firm as a system of economic activities and the legal form this activity takes. The malleability of the legal form of corporations coupled with the accountability mechanisms based on their boundaries invites a reflexive feedback loop that structures the boundary of the corpora- tion to minimize its accountability. By focusing on the opposing interests involved in the act of boundary drawing and the outcomes it produces, we seek to complement the current perspective on metric systems of valuation as facilitators of exchange (Muniesa et al. 2007) with a perspective that emphasizes their political-economic implications (Black 2010; Gilad 2014).

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Endnotes

1This is the case in several jurisdictions (e.g. Germany, France, Italy), where these numbers determine tax obligations to the state, but not in Anglo-Saxon countries.
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and finance leases. This article is the first which focuses on synthetic leases constitute a third lease type in Germany, beside operate institutions, Frankfurt 06/25/2015

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