

10 Minutes on Off-Balance-Sheet Arrangements*

What you need to know about emerging topics essential to your business. Brought to you by PricewaterhouseCoopers.

October 2009

The ongoing quest for visibility

Highlights:

- Both financial and nonfinancial companies will be affected by new off-balance-sheet rules.
- The impact goes beyond financial reporting to include financial metrics, operations, stakeholder communications, internal controls, and IT systems.
- With some strategic business relationships moving on to balance sheets, innovation and collaboration strategies may have to change.
- Some asset-based financing techniques may become less attractive.

The Star Trek television series and Harry Potter novels popularized the idea of having a cloak of invisibility to mask objects. Cynics suggest off-balance-sheet (OBS) arrangements serve a similar function in financial reporting. These critics have long maintained that OBS transactions mask risks and exposures that should be fully visible.

Many believed these structures would disappear in reaction to earlier scandals. Some were eliminated. But others remained and became controversial during the recent financial crisis.

In response, beginning in January, new rules will further restrict the use of OBS structures. These changes will add more transactions to the books of financial and nonfinancial firms.

Four ways to prepare for the changes

More restrictive criteria will put more transactions on the books, as the new rules will apply to both new and existing arrangements. The impact on income, balance sheets, operations and business relationships may be considerable.

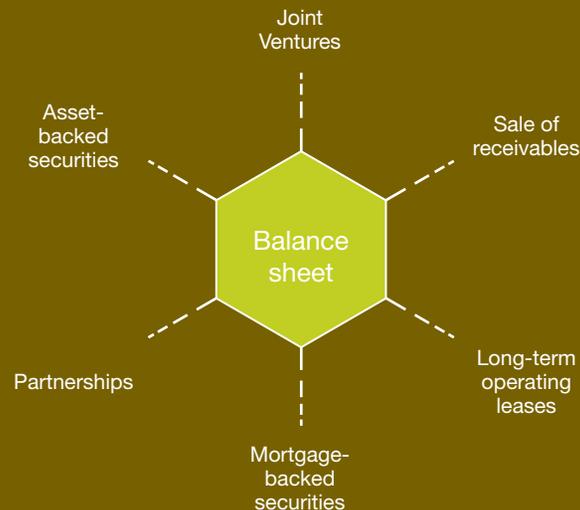
Companies should therefore consider:

- Evaluating how the new standards will impact existing OBS transactions and relationships.
- Remodeling financial statements to understand the impact on financial ratios and debt covenants.
- Analyzing the impact on planned acquisitions, financing arrangements and strategic relationships.
- Determining whether and how systems and internal control policies and procedures may need to be changed due to new balance sheet additions.

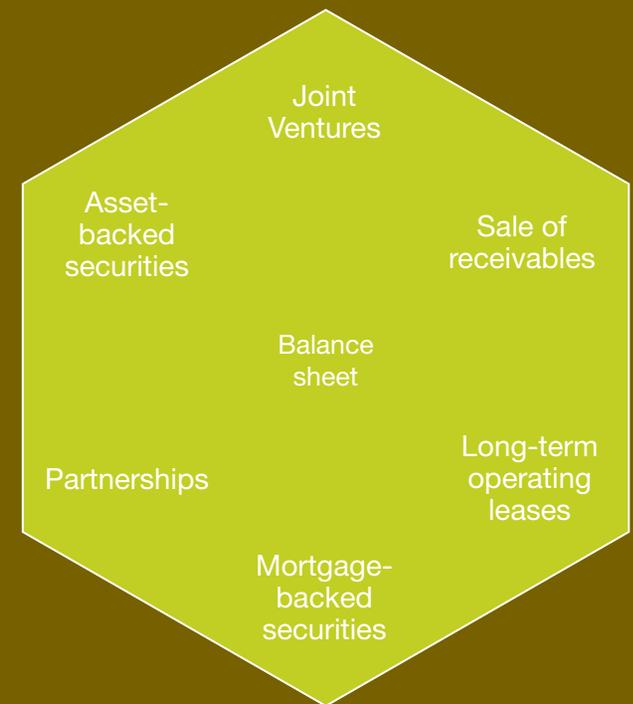
At a glance

Off-balance-sheet arrangements are used by many financial and non-financial companies for a variety of reasons, including managing risk, reducing borrowing costs, and collaborating with other companies.

New reporting requirements will bring more of these arrangements on to a company's books. The impact may reach beyond financial reporting to include current and future business ventures, financing, financial metrics, operations, stakeholder communications, internal controls, and IT systems.



Today



Tomorrow

Balance sheets will expand

Many observers believe financial innovations, including those that use OBS arrangements, have produced important economic gains. Yet critics contend the increased use of these structures also opened the financial system to unanticipated risk.

Post-Enron, standard-setters tightened the rules for OBS accounting treatment and disclosures. Now, following the recent financial crisis and concerns over the possible role played by some OBS entities, further enhancements will take effect next year.

Fewer receivables sold

One new rule,¹ which will mostly impact financing companies, will likely result in lending institutions moving fewer receivables and loans off their balance sheets. As a result, some asset-based financing methods may become less attractive or less useful.

More affiliates reported

Another rule² will change the way companies determine whether an affiliated entity should be included on the balance sheet.

The test for the “parent” (the party that must include the entity on its balance sheet) will require using more judgment and fewer bright lines to determine which party in a joint business relationship has control over key operating activities and substantial economic exposure.

Once determined, the affiliated entity will be included on the balance sheet and income statement of the “controlling beneficiary.” These determinations can be complex and result in conclusions not intuitively apparent from casual analysis.

¹ FAS 166 applies mainly to securitized transactions.

² FAS 167 outlines the criteria to determine if certain affiliated entities should be consolidated.

Some financing alternatives may be less attractive

Certain financing arrangements formerly were used to remove financial assets from balance sheets to free up capital and liquidity. Now, various types of asset-based financing may become less attractive, at least in the short term. Over time, however, further financial innovation likely will lead to new structures, products, and other alternatives.

Monetizing financial assets

To accelerate cash flows, companies often sell receivables rather than wait for payment. The new rules may change the way these sales are arranged.

Formerly, companies could sell receivables and retain an obligation to make good on those that later proved uncollectible. This recourse provision enabled companies essentially to borrow against receivables without recording a liability.

This will change in January. Most receivables sold with recourse will stay on a company's balance sheet until collected. Moreover, as no sale will occur, the cash received will be shown as a borrowing on a company's balance sheet. As a result, debt levels will increase.

Reach extends beyond financing of transactions

The potential reach of these new rules is significant. They may impact a wide array of industries and change the way businesses form, manage, and report strategic partnerships, joint ventures, and other relationships.

Reporting of corporate relationships may change

Beginning in January, one party to most joint ventures will be required to fully report the enterprise on its financial statements. This has important implications for companies that collaborate on long-term projects.

Intellectual property and R&D

The life sciences industry, for example, has a long product development cycle. To meet this sector's unique challenges, drug and biotech companies often collaborate to reduce costs, speed development, and pool their research resources.

These arrangements often involve creating a separate entity, such as a corporation, joint venture, or other format. Many of these entities are not reported in the financial statements of any party, except to reflect any capital invested or net earnings allocated.

But one of the parties in these relationships may soon have to reflect the assets, liabilities, income, and expense of the enterprise in its financial statements. Similar situations may arise in high-tech, aerospace and defense, chemicals, automobiles, and other industries.

Joint production and manufacturing arrangements

Some co-production arrangements may be affected, too. In the power industry, separation of power generation from transmission and distribution is widely used to finance new investments.

A long-term power purchase agreement may provide the distribution company input or control over the level of daily electrical production, the maintenance schedule, and the level and timing of the plant's capital expenditures. The distributor's control over these types of functions may qualify it—not the plant owner—as the controlling entity. Therefore, the plant and its operating results would appear in the distributor's financial statements, rather than the power producer's.

Similar determinations may occur in manufacturing and consumer and industrial product companies. Food and commodity processing commitments, product packaging arrangements and other vertically integrated manufacturing arrangements also may be affected.

Planning ahead: six areas for consideration

The potential reach of the new rules beyond accounting and reporting is significant. Management may want to consider how the following highlighted areas may be affected.

- **External financial ratios.** The impact will be felt in most financial measures of interest to third parties. This includes capital, leverage, liquidity, margins, earnings per share, return on equity, and debt covenants. Companies may want to inform investors and creditors of these changes in advance.
- **Internal financial measures.** Internal financial decisions may need to change, such as those related to bonus and pension plans, capital budgeting, hedging and financing.
- **Stakeholder communications.** Companies will be required to provide additional disclosures regarding OBS treatment and report changes and significant risk exposure. Management will also need to explain to stakeholders how newly consolidated entities may affect financial position and operating results.
- **M&A/transaction structuring.** Future acquisitions, financing arrangements, and strategic relationships may need to be designed differently to ensure that transaction economics, business objectives, and financial statement objectives are achieved.
- **Information systems and processes.** If new entities will be included in financial statements, how will results be captured by the “parent company” entity? There may be a need for system enhancements or integration. If an entity has to deconsolidate some operations, how will financial information be transferred to the new “parent”?
- **Internal controls.** For companies subject to internal control certifications, controls of newly consolidated companies would have to be incorporated into existing control testing regimens. Would a new, non-owner “parent” be allowed to implement and enforce its control standards? How would controls be audited and who would be responsible for correcting any control weaknesses?

Upcoming 10Minutes topics

Governance in the “New Normal”

After one of the most challenging years since the Great Depression, boards of directors are taking stock. *10Minutes on What Directors Think* assesses directors' views about regulation, executive compensation, and risk, among other key board concerns—both in light of the last 12 months and the anticipated economic recovery.

How to obtain higher quality valuations

Valuation is integral to business decision-making. Yet many factors can affect the amounts reported and the underlying assumptions used. *10Minutes on Valuations* looks at how companies can make higher-quality valuations and communicate those valuations more effectively to the marketplace.

How PwC can help

To have a deeper discussion about responding to the changes in off-balance-sheet reporting, please contact:

Tell us how you like 10Minutes and what topics you would like to hear more about. Just send an email to:
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