Off-Balance-Sheet Entity

Off-balance-sheet entity is common method used to engage in off-balance-sheet financing. The firm creates a legal entity in such a way that it is not required to consolidate this entity in its financial statements. Once this entity is created, the offending firm can use it in many ways to hide its debt or inflate its operating performance. The collapse of Enron is probably the most infamous instance of this kind of abuse.

To spot this abuse, read the footnote section with three particular types of footnotes in mind.

1) Look for a “related party” note. A firm must disclose transactions with entities in which it has significant influence. This information is usually contained in a related party note.
2) Look for a “contingent liability” note. These notes will indicate if a firm has guaranteed the debt of unconsolidated entities. Guaranteeing the debt of an unconsolidated entity is the typical way unscrupulous firms hide their debt in another entity.
3) Read any note on equity investments and “unconsolidated” investments. Try to determine if these notes indicate the firm has control over the operating policies of the unconsolidated investee.