

THE LEVEL OF ACCOUNTING KNOWLEDGE, OFF-BALANCE SHEET FINANCING AND INVESTORS' DETECTION ABILITY

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ARTICLE HISTORY

Received: 24 February 2023 **Revised:** 15 March 2023 **Published:** 27 March 2023

ABSTRACT

Off-balance sheet financing refers to the accounting methods management use to keep their debt-equity and leverage ratios low and cause investors to draw wrong conclusions. The literature reveals that off-balance sheet arrangements is incomprehensible to investors due to limited and obscure disclosure, and thus incur great costs on them. The objective of this research is to examine the effect of the level of accounting knowledge and off-balance sheet financing types on investors' detection ability. An experimental approach was adopted to achieve this objective, using 152 MBA students as a representative for non-professional investor. The research provides evidence that (1) investors' knowledge of creative accounting influenced their detection ability (2) off-balance sheet types significantly influenced the investors' ability to detect the off-balance sheet financing transactions, conditional on knowledge level in creative accounting. The finding suggests that knowledgeable investors could make use of relevant disclosures in the footnote to account for the off-balance sheet financing arrangements.

Keywords: Off-Balance Sheet Financing, Accounting Knowledge, Detection Ability

CITATION INFORMATION: Wongyim, H., Saksiriruthai, S., Rodkam, R., Akkharapratumwong, S., Tridhoskul, P., & Wongjantip, K. (2023). The Level of Accounting Knowledge, Off-Balance Sheet Financing and Investors' Detection Ability. *Procedia of Multidisciplinary Research*, 1(3), 6.

INTRODUCTION

Firms are motivated from various economic reasons to engage in off-balance sheet financing as these tools provide them with high debt rating, tax shelter, and impressive financial performance. Besides, off-balance sheet financing sometimes even resolves underinvestment problems arising from agency cost of debt (Mills and Newberry, 2005, Zhang, 2006, John and John, 1991, Shah and Thakor, 1987, Lim et al., 2003)

Enron, which was found to create over 3,000 off-balance sheet special-purpose entities (SPEs), was one of the most notorious examples involved in such a dishonest practice (Klee and Butler, 2002). Following the collapse of Enron, investors' trust in the publically available financial reports has eroded and the stock markets plunged due to accounting manipulation. Examples of the conventional concealing methods are the unconsolidated subsidiaries and lease accounting; nevertheless, even the users of the financial statements can refer to the accounting footnote for verification, the investors sometimes are met with limited disclosure, thus making the off-balance sheet arrangements even more incomprehensible to investors.

The biggest problem with off-balance sheet finance is its lack of visibility. Although firms are required by regulations to disclose information about their activities on leasing or related parties in the footnote, investors oftentimes find it difficult to make proper judgment of a company's underlying economic circumstances because firms often provide obscure and limited disclosure. For example, Enron formed several limited partnerships to hide the activities but its disclosure about these related-party transactions were cryptic and obscure, thereby making it very difficult, if not impossible, for a reader of the financial statements to discern their true nature (Ketz, 2003).

The inability to detect hidden financial risk could misdirect investment and thus incur great costs on investors. If investors underestimated the risk of a company, the company's stock would likely be overvalued. Bardos, Golec, and Harding (2012) provided evidence that investors had been misled by mistakes in the reported earnings at the time of initial earnings announcements of the incorrect earnings which were subsequently restated. In response to this problem, this study is concerned with the ability of non-professional investors to recognize and deal with off-balance sheet accounting in both less complex structure and more complex structure cases.

Therefore, the objectives of this research are (1) to examine the effect of the level of accounting knowledge on investors' detection ability and (2) to examine the effect of off-balance sheet financing types on investors' detection ability.

LITERATURE REVIEWS

Ketz (2003) categorized off-balance sheet techniques into two groups according to their available disclosures. The first group consists of those methods by which users of financial statements could use relevant footnote disclosures to reconcile the accounting numbers by reintroducing debts to the balance sheet (e.g. making analytical adjustment). The accounting techniques under this group are the unconsolidated subsidiaries (the equity method) and lease accounting since it is compulsory that disclosures pertinent to these accounting items be provided in the footnote and this information in turn enables the investors to make adjustments to the reported numbers. The second group comprises those methods without disclosures to assist users of financial statements with analytical adjustment. The accounting techniques belonging to the second group include debt hiding through asset securitization, special purpose entity (SPE) borrowing and synthetic lease since firms employing these complicated techniques rarely make available adequate information to aid investors in analytical adjustment.

This study restricts analysis to two types of off-balance sheet techniques, i.e., operating lease and unconsolidated subsidiaries. Operating lease is regarded as a surrogate for transparent (less

complex) off-balance sheet financing while unconsolidated subsidiaries as a surrogate for non-transparent (more complex) off-balance sheet financing.

Corporate managers use operating lease as a tool to hide debt off-balance sheet because of its legitimate advantages (Edman, 2011). When a company acquires an asset through debt financing, a liability present in its financial statements tells investors of the claims against the company's future revenue. However, if the asset is leased, no debt is posted on balance sheet even though the company has entered into lease contract and is committed to making lease payments in the future.

The unconsolidated subsidiaries (equity method) is one of accounting tricks that firm use to hide liabilities. When a company controls the operation of another entity, it tend to structure voting power or percent of shares holding to be less than significant portion to avoid consolidation and apply equity method instead. Under equity method, firm reports its investment in an affiliates company as a single line item in the balance sheet; net debts of the investee with its assets in the parent's investment account. Since asset are almost always greater than liabilities, this net amount show balance on left-hand side, thus exclude investee's debts from analysis.

The different levels of complexity in transaction and disclosure of information related to the transactions between operating lease and unconsolidated subsidiaries allow for test of the usefulness of the current footnotes. Prior research suggested that investors relied on footnote information for off-balance sheet transactions. Davis-Friday et al (1999) suggests that investor value obligation information provided in footnote; however, it is not adequate to substitute for the obligation recognized on balance sheet. Bauman (2003) found that currently provided disclosures related to equity method accounting are not sufficient for investors to make accurate and useful analytical adjustment.

Therefore, the usefulness of disclosure related to off-balance sheet transactions is of interest in this paper. This leads to the first research question with regards to the effect of off-balance sheet financing types on investors' detection ability. In the study, two types of OBS arrangements, i.e. operating lease and unconsolidated subsidiaries, were respectively used as proxies for less complex and more complex OBS. Disclosure levels of different kinds of off-balance sheet accounts are diverse.

The first hypotheses relate to the differences in detection rates for differing types of OBS. Craig and Walsh (1989) suggested that different window-dressing schemes were different in their visibility. For instance, a misclassified extraordinary item is more likely to be identified than an off-balance sheet financing arrangement as the latter is kept off the balance sheet. Breton and Taffler (1995) supported this idea and reported that analysts facing the practice of hiding debt with non-consolidated subsidiary, a form of off-balance sheet technique, had a lower correction rate than creating profit via asset disposal. Based on the aforesaid, it should be easier for investors to detect a less complex off-balance sheet practice than a more complex one. I thus posit the following hypothesis:

H1: Investors facing transparent OBS (operating lease) have greater propensity to detect OBS than those facing non-transparent OBS (unconsolidated subsidiaries).

Second, this research has expanded what is reported in Maines and Macdaniel (2000). Their result suggests that a certain level of accounting knowledge is a necessary condition that dictates the investors' willingness to reconcile the information in the footnote of a financial statement. This leads to the second research question with regards to the relation between the levels of investor's knowledge in creative accounting for differing types of off-balance sheet transactions.

The second hypotheses relate to the relation between the level of investor's knowledge in creative accounting for differing types of OBS. According to Maines and Macdaniel (2000), it is anticipated that highly knowledgeable of creative accounting tend to exhibit a higher ability

to detect off-balance sheet financing than those less knowledgeable. I thus posit the following hypothesis:

H2: Investors with highly knowledgeable of creative accounting have greater propensity to detect OBS than those less knowledgeable.

The conceptual framework of the study are as follow:

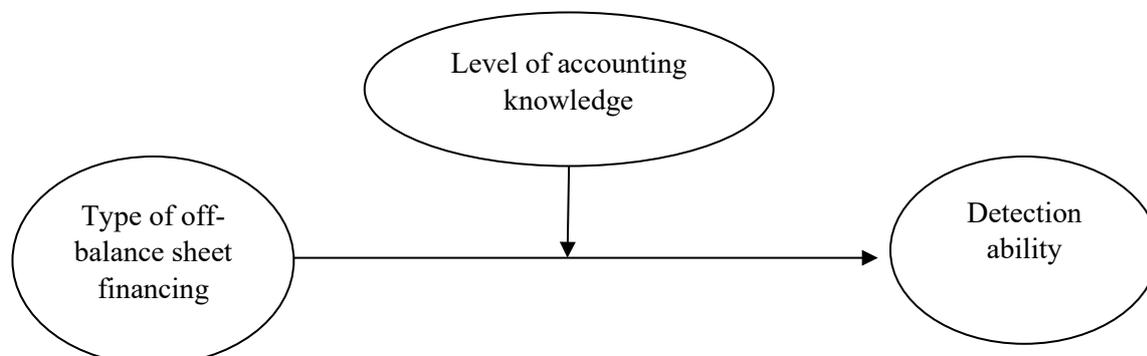


Figure 1 The conceptual framework

RESEARCH METHODOLOGY

The Participants used in the research were 152 MBA students of a Thai leading university. Elliott et al (2015) suggested that MBA students were able to detect different accounting policies which consequently led to different financial performance and that they also adjusted key financial ratios according to their findings.

The experiment begins with training about investment and compensation criteria. Then, all participants will be presented with the same information about the firm, presented good financial performance, except for information related to off-balance sheet transaction. The participants then go over the company's financial information. In general, the information includes overview of the company, financial statements (i.e., both balance sheet and income statement), key financial ratios, analysts' report containing analysts' consensus of EPS forecast and some analysts' comments. Afterward, participants' ability to detect off-balance sheet financing is examined whereby the participants were presented with various creative accounting techniques (e.g., income smoothing, take a big bath), including off-balance sheet financing, and were asked to estimate probability that the company is using one of the accounting scheme. Then, all participants will be asked to rate their knowledge in creative accounting to determine the level of knowledge. The experiment ends with the participants completing their demographic profile and providing answers to the manipulation check. The testing of hypotheses was carried out using descriptive statistics and analysis of covariance (ANCOVA).

RESEARCH RESULTS

Participants reported taking an average of 1.4 accounting classes, as well as having an average of 5.9 years of total work experience. Their mean investment experience was 0.6 years and 28% had invested in the stock market. Descriptive statistics for detection ability result are tabulated in Table 1.

Table 1 Descriptive statistics

Dependent variable: detection ability			
Knowledge level ^a (1 to 7)	Unconsolidated subsidiaries	Operating lease	Row mean
1	3.50	1.00	2.67
2	6.00	5.62	5.67
3	5.90	5.00	5.64
4	5.63	5.95	5.79
5	4.95	5.46	5.22
6	6.00	6.17	6.11
7	5.00	6.40	5.63
Column mean	5.39	5.72	5.57

^a Knowledge level were measured by asking participants to rate their knowledge in creative accounting from 1 to 7.

It was found that the investors' knowledge of creative accounting is positively correlated with their detection ability (Pearson's correlation = 0.135, $p = 0.09$). By comparison, those highly knowledgeable of creative accounting exhibit a higher ability to detect off-balance sheet financing than those less knowledgeable.

Table 2 ANOVA results**Dependent variable: detection ability**

	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	41.221	6	6.870	4.083	.001
Within Groups	243.983	145	1.683		
Total	285.204	151			

ANOVA result in Table 2 shows that there is a statistically significant difference in detection rates for differing level of knowledge. The investors' accounting knowledge influences their detection ability ($p = 0.01$). The finding is according to the researcher's prediction in which investor with different level of accounting knowledge exhibit a different level of ability to detect off-balance sheet financing. Therefore, to control for the participants' knowledge background, the level of knowledge were used as a covariate to control for group differences when performing the analysis of covariance test.

Table 3 Analysis of covariance results

Dependent Variable: Detection ability

Covariate: Knowledge level

Source	Type III Sum of Squares	df	Mean Square	F	Sig.
Model	4727.864 ^a	3	1575.955	847.299	.000
OBS Type	325.869	2	162.934	87.600	.000
Knowledge level	3.846	1	3.846	2.068	.153
Error	277.136	149	1.860		
Total	5005.000	152			

a. R Squared = .945 (Adjusted R Squared = .944)

Table 3 shows that the type of off-balance sheet financing is statistically significant ($p = 0.00$). This suggest that off-balance sheet financing types influenced on investors' detection ability,

conditional on knowledge level. Independent sample t-test also shows that the investors under the operating lease condition (mean = 5.72) exhibit a higher detection ability than those under the unconsolidated subsidiaries condition (mean = 5.39; one-tailed $p = 0.01$). The investors under unconsolidated subsidiaries condition possessed a lower ability to detect OBS than those under the operating lease condition since an equity-method transaction is typically more complex in terms of both the nature of the transaction and the relevant disclosures in comparison with that of operating lease.

DISCUSSION & CONCLUSION

This study examines how off-balance sheet financing types and the level of accounting knowledge affect investors' ability to detect off-balance sheet financing in manipulated financial reporting. Overall result supports my prediction. It was determined that the level of detection ability is subject to the complexity of OBS transactions (i.e. OBS types). The implication of the findings is for the relevant regulatory bodies to revisit the disclosure format related to complex OBS (i.e. unconsolidated subsidiaries) so as to lessen the complexity burden borne by the investors. Moreover, this research is expected to raise investors' awareness on the usefulness of disclosure information in the footnote section. Furthermore, the research results showed that the investors' knowledge of creative accounting is positively correlated to their correction's ability. While previous research documented that footnote disclosure is insufficient and less useful than the recognized information (Bauman, 2003; Maines & McDaniel, 2000), this current research findings indicated that, given the investors' knowledge of creative accounting, even the non-professional investors could avail themselves of disclosure information pertaining to the OBS transactions whereby the concealed debts are re-introduced into the balance sheet. The implication of the findings for accounting researchers is that investors' knowledge of creative accounting should be treated as a control variable in accounting research on investors' ability to detection off-balance sheet financing.

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Data Availability Statement: The raw data supporting the conclusions of this article will be made available by the authors, without undue reservation.

Conflicts of Interest: The authors declare that the research was conducted in the absence of any commercial or financial relationships that could be construed as a potential conflict of interest.

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