Barents Report:
Potential Impacts of Asset/Liability Framework in Accounting

Preliminary Investigation of Potential Impacts of Changing to an Asset/Liability Framework in Accounting for Leases

Prepared by: DEF, A KPMG Company, Washington, D.C.

October 5, 1998

Table of Contents

Preface

Barents Group LLC, a KPMG Company, was commissioned by the Equipment Leasing Association of America to prepare this report on the potential impacts of a fundamental change in the conceptual framework upon which current lease accounting standards are based. Our report relies in part on interviews of members and staff of the Financial Accounting Standards Board, representatives of the Association for Investment Management and Research, a representative of the Chief Accountant's Office of the U.S. Securities and Exchange Commission, and staff of Standard & Poor's Rating Service. We would like to express our gratitude to all those who participated in the interviews for the time they gave us and for their frankness in discussing their views. We hope that we have faithfully represented their views in this report, and take full responsibility for any errors, omissions or misstatements of their views. The scope of the interviews conducted was designed to reflect the views of users of financial statements and accounting standard setters. It may not necessarily reflect the views of the lessor and lessee communities.

Top (#top)

Executive Summary

Barents Group LLC, a KPMG Company, was asked by the Equipment Leasing Association of America to conduct a preliminary study of the potential impacts of a change from the current "risk/rewards-based" framework for lease accounting to an "asset/liability-based" framework in which all noncancelable leases of some minimum duration would be capitalized on financial statements. The study considers both potential informational impacts and economic impacts, with a primary focus on lessees.

The report presents the results of interviews with selected accounting and financial analysis professionals, as well as a qualitative discussion of potential economic impacts of a change in lease accounting standards. Representatives of the Financial Accounting Standards Board, the Association for Investment Management and Research, the U.S. Securities and Exchange Commission, and Standard & Poor's Rating Service were interviewed. The objective of these interviews was to obtain the views of key financial professionals regarding (a) the perceived shortcomings of the current lease accounting standard (as embodied in FASB Statement of Financial Accounting Standards No. 13); (b) how -- and how successfully -- they analyze the impact of operating leases on lessees' financial statements using the information contained in the mandated disclosures; and (c) the extent to which they believe that shortcomings of the current standard would be remedied by the adoption of a new accounting framework in which substantially all leases would be capitalized as assets and liabilities on lessees' financial statements.

The people interviewed for this study expressed a strongly held belief among accounting standards-setters, regulators, and financial accounting professionals that the current accounting standards for leases have not worked as intended. According to some of those interviewed, the intention of SFAS 13 was to put more financing transactions on lessees' balance sheets, and they believe that this has not occurred. All of the parties interviewed believe that the current lease accounting standards are too complex, and all are concerned that the standards are not being applied uniformly in practice. However, the format of the interviews did not permit a more detailed discussion of specific cases or examples that would illustrate the asserted lack of uniform application of the current standards. It also should be noted that, although many of those interviewed had given lease accounting issues considerable thought, they were not generally specialists in lease accounting. It may be the case that, for some individuals, some of their concerns regarding the complexity of current standard reflect a lack of familiarity with the leasing industry.

Without exception, the interviewees expressed the view that additional information is required by investors and creditors in order for them to make more reliable evaluations of the performance and creditworthiness of companies that engage in operating leases. Those interviewed further believe that the current standard provides too many opportunities for abuses, and leads to a great deal of economically unproductive financial activity designed solely to gain off-balance-sheet treatment for leases. However, some of those interviewed acknowledged that the leasing cases that they hear about most tend to be the extreme cases. And, it is unclear from the interviews how large a fraction of actual lease cases involve the sorts of problems about which they are concerned. An empirical investigation would be required to show what fraction of actual leasing transactions are of the type that regulators and standard-setters consider to be "abusive."

Most of the people interviewed believe that an asset/liability framework, under which substantially all leases would be capitalized as assets and liabilities on lessees' balance sheets, would go a long way toward remedying the perceived problems with the current standard. Increased disclosure of the characteristics of lease contracts was also considered to be desirable. However, only a few of those interviewed appeared to appreciate the fact that the McGregor approach would not automatically achieve the improvement in comparability asserted by that author.

The fact that the comparability issue appears to be poorly understood by many financial accounting and analysis professionals suggests that this issue should studied in greater depth. The results of such a study would be a useful contribution to discussions regarding the future of lease accounting. The Equipment Leasing Association and other parties could play a role in educating interested parties about the complexity and nuances of the comparability issue. Without such efforts, standards-setters, regulators, and financial market professionals may remain focused on the apparent simplicity of application of the McGregor approach compared to the current standard.

The analysis in this report of potential economic impacts of a change in the lease accounting framework is intended as a preliminary and qualitative analysis to identify the various channels through which impacts may occur. The result is a list of issues and questions that may be subjected to more rigorous quantitative analysis in the future.

Other things held constant, the principal financial-statement impacts of the change in accounting framework on lessees with operating leases would be (a) an increase in reported financial leverage, (b) a decrease in reported asset-based measures of performance (such as return on invested assets), and (c) a decrease in reported interest coverage. In other words, reported financial statements would appear to show a decline in the profitability and creditworthiness of affected lessees when, in fact, nothing of economic substance has changed. If markets were perfectly efficient in processing information, such cosmetic changes would be expected to have no economic consequences. However, if investors or analysts reach less favorable conclusions about lessee performance and creditworthiness when operating leases are capitalized -- or if lessee managers believe that they do -- then the apparently cosmetic change in accounting standards can have real effects on lessee financing decisions. These effects may or may not entail significant costs to lessees, but the resulting decline in demand for leases is expected to cause wealth and job losses in the leasing industry.

Empirical evidence on the effects of the adoption of SFAS 13 suggests that the adoption of an asset/liability accounting framework for lessees would lead to considerable rearranging of the capital structures of companies that currently engage in operating leases. These changes would include reductions in outstanding debt, increases in equity, and/or substitution from leases to nonlease financing. Such shifts in financing policy would entail temporary transitional costs for lessees, and the general decline in demand for leasing products would result in permanent losses to some segments of the leasing industry. However, the existing empirical evidence is insufficient for drawing conclusions about the size and economic significance of such potential impacts.

Several areas are suggested for future research to quantify the potential economic impacts. These include further investigation of the extent to which markets efficiently process information about firms' leasing activities; an empirical investigation of the economic impacts of past accounting standards changes that have led to increased reported leverage; an empirical investigation of the potential for distributional impacts across lessees in different industries, and across lessors and lessees engaging in different kinds of lease transactions and involving different kinds of assets; and a quantitative analysis of the likely changes in lessee financing decisions when off-balance-sheet financing is no longer available.

Top (#top)

Introduction

Barents Group LLC, a KPMG Company, was asked by the Equipment Leasing Association of America ("ELA") to conduct a preliminary and qualitative study of the potential impacts of a change from the current "risk/rewards-based" framework for lease accounting to an "asset/liability-based" framework in which all noncancelable leases of some minimum duration would be capitalized on financial statements. The study considers both potential informational impacts and economic impacts, with a primary focus on lessees.

The primary impetus for a reconsideration of lease accounting standards in the U.S. is a general movement toward harmonization of accounting standards across countries. This movement derives, in turn, from the increasing internationalization of capital flows as companies in various countries increasingly look to foreign markets to raise equity and debt capital. Both the Financial Accounting Standards Board ("FASB") and the U.S. Securities and Exchange Commission (SEC) have been actively involved in discussions with the International Accounting Standards Committee ("IASC") and with other national accounting standards-setting bodies regarding harmonization. This activity extends beyond the realm of lease accounting, and encompasses standards in general.

The Current Lease Accounting Standard: The current FASB standard for lease accounting is Statement of Financial Accounting Standards ("SFAS") No. 13, "Accounting for Leases" (as amended), which was issued in November 1976. The standard may be summarized as follows. Lessees must classify leases at their inception as either capital or operating leases based upon whether they have assumed the substantial risks of ownership of the leased property. Under this "risk/rewards" approach, a lease meeting any one of four criteria must be classified as a capital lease by the lessee:

1. The lease transfers ownership of the property to the lessee at the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property (except in the case of land or when the lease term begins within the final 25 percent of the asset's economic life).
4. The present value of the minimum lease payments equals or exceeds 90 percent of the fair value to the lessor of the leased property.

Leases not meeting any one of these four criteria are considered to be operating leases, and no asset or obligation is reported in the lessee's financial statements, because no purchase is deemed to have occurred. Operating lease payments are recorded as rental expense, and are recognized on a straight-line basis unless another, systematic basis provides a better representation of the use benefit derived from the leased property.

In contrast with operating leases, capital leases must be reported on the lessee's balance sheet as an asset and a corresponding liability. At the commencement of a capital lease, the lessee records as an asset and a liability the present value of the minimum lease payments (excluding any amounts to cover maintenance, property taxes or insurance provided by the lessor). The discount rate used must be the lower of the lessee's incremental borrowing rate or the rate implicit in the lease (if this can be estimated). However, if the present value of the minimum lease payments using this rate exceeds the cost or fair value of the property, then the lessee must use a higher rate that reduces the present value of those payments to the fair value. An asset acquired under a capital lease is depreciated by the lessee, similar to any other depreciable asset. In addition to depreciation, the lessee records periodic interest expense on the lease, based on a constant periodic interest rate applied to the declining balance of the lease obligation. The interest rate is the same as that used to compute the initial present value of the liability.

SFAS 13 also requires that financial statements contain certain disclosures regarding leases. In short, lessees must disclose the gross amount of capitalized leased assets, the future minimum lease payments for each of the five succeeding fiscal years, and the aggregate amount of minimum lease payments thereafter. For operating leases, lessees must disclose the future minimum lease payments for each of the five succeeding fiscal years, and the aggregate amount of minimum lease payments thereafter. Separate disclosure of minimum sublease rentals receivable from noncancelable subleases is also required for both capital and operating leases. In addition, information regarding renewal terms, purchase options, contingent rentals, escalation clauses, and any restrictions on dividends, additional debt and leasing is also required, though such disclosure is usually general in nature.

A Proposed New Lease Accounting Framework: In July 1996, FASB published a special report on the subject of lease accounting, which has come to be known as the "McGregor Report" for its principal author, Warren McGregor of the Australian Accounting Standards Board. The McGregor Report represents the efforts of a working group consisting of board members and senior staff members of the standards-setting bodies of Australia, Canada, New Zealand, the United Kingdom, and the United States, as well as the staff of the IASC. The report discusses perceived shortcomings of the current lease accounting standards of the participating countries, which are based on the framework of "risks and rewards from ownership," and proposes a new framework for lease accounting in which all noncancelable leases with initial duration of more than one year would be capitalized as assets and liabilities on lessees' balance sheets. In other words, operating lease treatment would not be allowed for long-term noncancelable leases. Our report will discuss the potential impacts of switching from the current "risk/rewards" framework to an "asset/liability" framework for lease accounting. It does not address the relative merits of these two frameworks.

Objectives of This Study: The objective of the first stage of the investigation was to interview selected accounting and financial analysis professionals to obtain their views regarding the current lease accounting framework, as embodied in the SFAS 13, and the framework advocated by McGregor and others. Those interviewed included accounting standards-setters and users of financial statements. The views of lessors and lessees were not sought for the purposes of this study.

We sought the interviewees' views on the extent to which the current lease accounting standard is misleading to users of financial statements, and whether they believe that a change to an asset/liability framework would improve the financial information available for analyzing entities that engage in leasing. The second stage of the investigation consists of a qualitative discussion of the potential economic consequences of a change to an asset/liability lease accounting framework. The discussion includes potential distributional impacts among lessees, impacts on the cost of a lease, and impacts on financing decisions of actual or potential lessees.

The final section of this report summarizes the findings of the preliminary investigation and recommends avenues for more in-depth, quantitative investigation of potential economic impacts of a change in the framework for lease accounting.

Top (#top)

Interviews with Accounting and Finance Professionals

A primary stated objective of those who advocate a change from the current risk/rewards-based lease accounting framework to an asset/liability-based framework is to improve the quality and informativeness of financial statements to external users, such as actual and potential investors and creditors. Therefore, it is important to determine the extent to which the current lease accounting framework is considered deficient in this regard, and whether financial accounting practitioners believe that asset/liability-based framework will result in, for example, greater "understandability," "usefulness," and "comparability." We recognize the benefits of these objectives of financial reporting, but it remains an unsettled question whether the specific approach to lease accounting advocated in the McGregor Report would achieve these objectives or whether alternative approaches would be more effective.

Interviews with interested financial professionals were conducted to obtain their views on the current accounting standard and the framework advocated by McGregor. While the focus of each interview differed to some extent depending on the interests and expertise of the participants, each of the interviews was organized around the following key issues.

- Whether financial professionals and investors are misled by the current accounting treatment of operating leases.

- Whether current disclosures are sufficient to allow a full financial analysis of lessee companies.
- Whether an asset/liability-based framework would result in improved information compared to analysis of lease accounting information as currently presented.

The following interviewees were selected in consultation with ELA: representatives of the Financial Accounting Standards Board, the Association for Investment Management and Research ("AIMR"), the Office of the Chief Accountant of the U.S. Securities and Exchange Commission ("SEC"), and Standard and Poor's Rating Service. FASB is the private-sector organization that establishes standards of financial accounting and reporting that govern the preparation of financial reports. Standards established under the due process procedures of FASB are officially recognized as authoritative by the SEC and the American Institute of Certified Public Accountants. The SEC is an independent, nonpartisan, quasi-judicial regulatory agency with responsibility for administering the federal securities laws. The SEC also regulates firms engaged in the purchase or sale of securities, people who provide investment advice, and investment companies. AIMR is an international, nonprofit organization of more than 33,000 investment practitioners and educators in 77 countries. Its mission is "to serve its members and investors as a global leader in educating and examining investment managers and analysts and sustaining high standards of professional conduct."

Standard & Poor's is one of the largest and best known providers of risk evaluation, credit analysis and credit rating services. It provides analysis of the creditworthiness of issuers of public debt around the world.

The views expressed by participants in each of the interviews are summarized below. The specific questions posed and interviewees' responses to them are provided in detail in the Appendix 1 of this report.

Financial Accounting Standards Board

Representatives of FASB were interviewed at their offices in Norwalk, Connecticut. Representing FASB at the interview were James Leisenring, Deputy Chairman; Timothy Lucas, Director, Research and Technical Activities; Leslie Seidman, Deputy Director, Research and Technical Activities; and Neel Foster, FASB Board Member. Both Leisenring and Lucas represented FASB in the IASC working group discussions that resulted in the McGregor Report.

Summary and conclusions: The participants were very clear in expressing their view that the right to use a leased asset represents a real asset of the firm, that lease payment obligations represent real liabilities, and that they should both be recorded as such on the lessee firm's financial statements. They believe that making more and better information available to the marketplace would be beneficial, and that capitalization of most leases would lead to more and better information about companies engaged in leasing. They further believe that the current lease accounting standards are too complex — that they should be easier to understand and apply.

They were equally clear in expressing their view that potential economic impacts of a change in accounting standards should not be a consideration of accounting standards bodies, except to the extent that improvements in financial accounting and reporting help to reduce uncertainty in the market and lead to a more efficient allocation of economic resources. They stated that it is inevitable that any FASB pronouncement will have consequences that some consider to be undesirable — whether because of true economic harm or because of a loss of control over information. But they have found in the past that most predictions or assertions of economic harm resulting from changes in standards could not be supported by data.

Even if such assertions were borne out, FASB regards them as resulting from market decisionmakers' having more and better information and, thus, as not undesirable in the greater market context. They are more concerned with broad economic efficiency objectives than with impacts of changes in standards on individual industries, industry segments, or companies. They regard conformity with the objectives of financial reporting ("qualitative characteristics of accounting information"), as expressed in FASB Statement of Financial Accounting Concepts No. 2, as their primary criterion for formulating and adopting new standards, since pursuit of these objectives is believed to lead to greater economic efficiency.

U.S. Securities and Exchange Commission

The issues of interest for this study were discussed at a general level by telephone with Mary Tokar, an SEC Senior Associate Chief Accountant for international accounting and auditing standards. Tokar has been involved with international accounting standards-setting projects. According to Tokar, the SEC staff believe that the current standards are too complex, are not well understood by accounting practitioners, and are not applied uniformly across practitioners dealing with similar transactions. They consider the recent changes made to international standards by the IASC to be an interim step on the way to a complete restructuring of lease accounting standards, and they believe that the McGregor approach should be considered. However, the SEC has not yet undertaken a formal study of what form a new standard should take, and such a study is not currently a priority of the SEC.

Association for Investment Management and Research

The Chair of the Financial Accounting Policy Committee (FAPC) of AIMR agreed to include our interview in the agenda of their quarterly committee meeting in New York City. AIMR includes the Institute of Chartered Financial Analysts and the Financial Analysts Federation. The FAPC is a standing committee of AIMR charged with maintaining liaison with and responding to initiatives of bodies that set financial accounting standards and regulate financial reporting disclosures (both in the U.S. and internationally). The FAPC regards itself as representing the views of securities analysts, portfolio managers, strategists, consultants, and other investment professionals who specialize in the valuation and analysis of capital markets. The committee members present at the meeting were as follows.

Trevor Harris	Gabrielle Napolitano
Peter Knutson	Trevor Nysetvold
Donald Korn	David Schwartz
Peter Lincoln	Ashwinpaul ("Tony") Sondhi
Erick Lucera	Tom Stringfellow
Patricia McConnell	Rebecca Todd
Patricia McQueen (committee chair)	Gerald White

These members include academics, financial analysis practitioners, and company financial professionals. Joseph Anania, a FASB Board member and liaison to AIMR, also attended the meeting as a guest for discussions on issues unrelated to leasing, but did not actively participate in the interview. The views expressed by participants in each of the interviews are summarized below. The specific questions posed and interviewees' responses to them are provided in detail in the Appendix 1 of this report.

Summary and Conclusions: AIMR's official position is that all leases (and all other executory contracts) with an initial term of more than one year should be recorded as financing agreements (as expressed, for example, in their 1993 position paper, "Financial Reporting in the 1990s and Beyond"). They should be recorded on balance sheets as receivables and payables, respectively, of lessors and lessees at the present value of the future promises to receive or pay cash. The symmetry of entries between the lessee and lessor in a given transaction was specifically emphasized. More generally, AIMR's position is that an enterprise should recognize a financial asset or financial liability on its balance sheet when it becomes a party to the contractual provisions that comprise any financial instrument, because the enterprise becomes subject to the benefits and risks inherent in the instrument and, therefore, regards the essential conditions of being an "asset" or a "liability" as having been met when the contract is entered. Their position is summarized by the following excerpt from a 1993 AIMR position paper.

We all have struggled to understand the immense body of detailed rules that govern accounting for leases. Sometimes it seems as if the only persons having sufficient motivation to study their particulars are those who need to write lease contracts that produce desired outcomes. We know that the criteria for distinguishing between capital lease and operating lease set forth in Financial Accounting Standard No. 13 and its supplements are arbitrary and their application often is willfully capricious. Sometimes it seems as if the opportunities to manipulate the rules are *in direct proportion to their copiousness.*

We believe the rules could be simplified. First, we would drop the current dichotomy between accounting standards for leases and those for other executory contracts. We would have them treated the same way. Second, we believe that financial reporting would be improved considerably if all executory contracts of more than one year duration were capitalized. That would result in the recognition of all receivables and payables at the present value of future legally enforceable commitments to exchange cash in the future.

The members of the FAPC appear to be unanimous in their support of this view. Their view is based on their perspective as users of financial statements. They believe that financial statements would be more informative, or could be more readily interpreted by users if leases were capitalized; and they consider capitalization to be necessary in order to achieve a meaningful degree of comparability across companies with different equipment financing arrangements.

However, Barents observed a general lack of recognition among the committee members that capitalization of leases will not achieve the goal of comparability. For example, committee members reported that they currently recast financial statements of lessees and would likely do so in the future under an asset/liability framework, albeit in different ways. Whether the "McGregor approach" to lease accounting is adopted or the current U.S. approach is modified to eliminate perceived abuses, the financial statements that result will still not be directly comparable without further interpretation and restatement on the part of their users. This is because the interest component of a capitalized lease will not generally resemble the interest cost that would be incurred if the same asset were financed by debt.

In addition, different leasing arrangements would lead to differences in financial ratios across otherwise identical companies even if the leases were capitalized. This occurs for several reasons. For example, two otherwise identical leases for the same asset would have different estimated present values if they had different initial lease terms. Other things equal, two leases would have different periodic lease rental payments — and, thus different estimated present values — if they included different renewal option terms or different contingency payment terms. These and other differences among leases that reflect the different business circumstances and needs of different lessees will lead to differences across lessees in the capitalized value of the same asset. As a result, some analysts will continue to be mislead by standard financial ratios if they simply apply the ratios in a mechanical manner without further quantitative or qualitative analysis. To the extent that AIMR representatives believe that comparability would be achieved if all leases were capitalized, there may be opportunities for ELA and others to educate them on this issue.

Standard and Poor’s Rating Service

Two representatives from Standard & Poor’s Rating Service ("S&P") were interviewed separately by telephone: Phillip Baggaley of the Aircraft Lease Finance division and Solomon Samson, the Chief Rating Officer for Corporate Finance. The interview questions paralleled those of the interview with AIMR representatives. Since these interviews were relatively brief, we have included a complete discussion of them in the body of this report. In the course of the interviews, we obtained specific information regarding the estimation method by which S&P adjusts financial statements to reflect operating leases. This method is described in Appendix 2.

Phillip Baggaley: Baggaley mainly described the method by which S&P analysts adjust the financial statements of lessees to reflect their characterization of the assets and liabilities embodied in operating leases. While recognizing that S&P’s method for making these adjustments employs various simplifying assumptions, they believe that their method is superior to methods (such as standard capitalization multiples) typically used by many other analysts, including analysts at some other credit rating agencies.

S&P has adopted a relatively straightforward financial model for adjusting the financial statements of firms whose debt it rates to reflect the impacts of operating leases on key financial ratios used to judge creditworthiness. According to S&P, their operating lease analytical model "is intended to make companies’ financial ratios more accurate and comparable by taking into consideration all assets and liabilities, whether they are on or off the balance sheet." It is claimed that the model also helps to improve analysis of how profitably a firm employs both its leased and owned assets. They believe that, by adjusting the capital base for the present value of lease commitments, the return on capital better reflects actual asset profitability.

Regarding potential pitfalls of an asset/liability approach to accounting for leases, Baggaley recognized in his comments that capitalization generally would not result in complete comparability among firms — i.e., that it would result in different valuations and financial ratios for ostensibly identical firms utilizing identical assets that differ only in terms of the structure of their lease commitments. However, he does not consider this to be a serious concern in his work, which involves securitizing leases. In any case, absent a wholesale change in standards, a couple of simple changes in footnote disclosure requirements would be sufficient to greatly improve the accuracy of their model for purposes of credit analysis: disclosure of (1) future annual lease rental obligations beyond the first five years, and (2) the appropriate weighted-average discount rate (implicit lease interest rate) to use in estimating the present value of operating leases.

Solomon Samson: Samson is responsible for general oversight and quality control in the credit rating activities of S&P's Corporate Finance Division. He has been with S&P for 18 years, and his sector experience and responsibility include industrial companies, transportation and utilities. According to Samson, S&P has always tried to make adjustments to reported financial statements to account for differences across companies in their accounting treatment of leases. He confirmed that their analytical methods for accounting for operating leases follow the financial model described by Baggaley and discussed below, though there is some variability in the application of the model depending upon the information provided by the company being rated and the abilities of the reviewer.

In addition to considering quantitative information in the form of conventional financial ratios, they recognize that there is a potential for differentiating among lessee companies based upon qualitative information about the terms and structure of their leasing arrangements (such as the existence of renewal options and the likelihood that they will be exercised) and the kinds of assets leased, to the extent that such information can be obtained from individual companies. For example, they consider the risk implications of the term of a lease relative to the useful life of the asset under lease. In considering the risk implied by leasing arrangements, they recognize that the flexibility implied by a short-term lease (compared to a long-term lease or a purchase) may be a positive or negative indication, depending on the physical asset in question. For the case of computer, where the risk of obsolescence is high, or for the case of a retail store, the flexibility of a short lease term may be a positive sign of risk-reduction efforts. However, in the case of long-lived dies used in a manufacturing process, short lease terms may be a caution sign for the credit rater, because it suggests that the leasing transaction was structured solely to obtain favorable accounting treatment and suggests an attempt to hide information.

They also recognize that the existence of renewal options in many cases may lead to a tendency toward understatement of financial leverage in their analysis. To the extent that such options are typical in a particular industry (e.g., retail stores), they may take them into account in their qualitative analysis. For example, they may base their analysis of a lessee company on an assumption that renewal options will be exercised if renewals have been observed to be common in that company's industry.

Such issues generally can only be explored with the cooperation of the company being rated — the kinds of assets obtained under leases and the terms of specific leases are not among the required financial statement footnote disclosures. Samson stated that, in practice, S&P goes to the trouble of pursuing such additional detailed information only for a minority of rated companies.

Regarding a potential change in lease accounting standards to a risk/rewards-based framework, Samson considered the impacts on the quality of accounting information from two distinct angles. First, as a purely static exercise — holding lessee behavior fixed — he considers that a purely cosmetic accounting change requiring capitalization of most leases would be a good thing from S&P's point of view. He believes that it would lead to a better representation of the financial risks undertaken by lessees, and would eliminate the inaccuracies inherent in trying to estimate the financial statement impact of operating leases. While they do the best analysis they can with the information provided by companies, the lessees' own present value calculations would be more accurate than S&P's. He stated that, if such a requirement were adopted, they would immediately drop their financial model for estimating the impact of operating leases. Nevertheless, Samson does recognize that neither S&P's current methods nor an asset/liability accounting approach result in entirely satisfactory answers about credit risk or in complete comparability among companies with different leasing and/or ownership arrangements.

Second, Samson considered the possible lessee behavioral changes that could result from a change in the lease accounting standard. He characterized the interaction between lessees and accounting standards bodies and "an ongoing game of cat-and-mouse," and expects that lease market participants will find whatever loopholes may exist in any new standard that is adopted. While he could not speculate on what the specific lessee reactions might be, he suggested that some lessees may take actions that increase their risk, while others may actually lower their risk.

That is, the benefits of increased disclosure may, in some cases, be offset to some extent by the costs of increased risk. He agreed that some lessees may choose to take on greater business risk by adopting shorter-term leases. To the extent that such activity is observed to occur, he expects it to be viewed negatively by credit raters, because it would represent an attempt to hide information.

Samson does not believe that the adoption of an asset/liability framework would lead to large costs associated with the violation of leverage restrictions contained in debt covenants. His opinion is based in part on his observation of reactions to the adoption of SFAS 106, which required that employer promises to provide health insurance coverage to employees after their retirement be recorded at their present value as long-term liabilities. He said that many people submitting comments on proposed SFAS 106 claimed that the standard would have large economic costs because it would increase leverage and cause the violation of debt covenants. Samson said that he is unaware that there were any actual problems of this nature after SFAS 106 was adopted, and he is skeptical of the notion that it would be an issue in the case of a change in lease accounting (though he agrees that the potential for an impact would be much greater in the case of the McGregor approach than for SFAS 106). A systematic empirical study of the effects of SFAS 106 may shed some light on the potential for impacts from a change in lease accounting standards.

Other reasons Samson believes that debt covenants violations will not be a problem include the following: (a) it is not an issue for investment-grade companies, (b) well-crafted covenants would probably have provisions to deal with such accounting changes, and (c) private debt issues could be easily renegotiated. In short, he does not expect technical default to be "a broad, sweeping problem."

[Back To Table of Contents(#TOC)]

Qualitative Discussion of Potential Economic Impacts

In this section, we consider the potential economic impacts of a change from the current lease accounting standard to an asset/liability-based framework requiring capitalization of all noncancelable leases with initial terms of more than one year. The objective is to identify possible ways in which economic impacts might manifest themselves, and which might be quantifiable through further research.

First, it should be noted that a requirement that all long-term noncancelable leases be capitalized would not affect a considerable segment of the leasing market. Existing capital leases, which must be capitalized under the current accounting standard, would not be affected. Short-term operating leases with terms of one year or less would not be affected. And, it may continue to be profitable to engage in tax-driven leveraged leases of long-lived assets that would otherwise have been structured as operating leases under the current standard. Though the benefits of off-balance-sheet treatment would be lost in such leveraged leases, the tax benefits are expected to continue to make these transactions profitable even if the leases must be capitalized by lessees. In addition, one of the key motivations for "synthetic leases" (also known as "off-balance-sheet debt") — namely the ability to characterize them as operating leases for accounting purposes — would be eliminated under an asset/liability framework.

Next, in a superficial analysis, it may seem that the requirement that leases be capitalized on lessees' books should have no important economic effects: it is essentially a cosmetic change in the presentation of accounting information. Lease capitalization would lead to increases in liabilities and assets, together with increases in the ratio of reported debt to equity and the accounting rate of return as measured by the return on invested assets. But these book accounting changes would be merely cosmetic and would not reflect any changes in the lessee's underlying economic situation or real cash flows. To understand why an apparently cosmetic accounting change may have real economic effects, it is helpful to ask why lessee company managers might be motivated to alter their economic decisions in response to such an accounting change — that is, whether the accounting change may lead to real changes in economic incentives that alter the economic behavior of lease market participants.

Impacts Suggested by Economic Theory of Leasing Decisions

The lease-versus-buy decision provides a useful framework for identifying some of the potential avenues for real economic impacts. In their seminal theoretical paper on this subject, Smith and Wakeman (1985) identified eight major nontax factors that provide an incentive to lease an asset rather than purchase it. These factors include characteristics of the lessee, the lessor, and the asset. Of the eight factors, only the first four listed below bear directly on the operating-versus-capital lease choice.

1. The period of use of the asset is short relative to the overall useful life of the asset.
2. The lessor has a comparative advantage in reselling the asset.
3. Corporate bond covenants contain provisions restricting the financing policies that the company must follow, such as restrictions on leverage or on the issuance of senior debt.
4. Management compensation is explicitly or implicitly based on returns to invested capital, thereby giving managers an incentive to lease assets in order to keep the denominator of this ratio low.
5. The asset's value is relatively insensitive to use or abuse (i.e., the owner takes better care of the asset than a lessee).
6. The asset is not specialized to the firm using it.
7. Lessee ownership is closely held so that risk reduction (by leaving residual value risk with the lessor) is important.
8. Price discrimination opportunities — i.e., the lessor/manufacturer has market power and can generate higher profits by leasing the asset than by selling it.

The first two factors — short periods of use and the lessor resale advantage — favor the use of operating leases and seem naturally to lead to leasing structures that would not require capitalization under the current FASB accounting standard. The second two factors — restrictive bond covenants and management compensation — may provide incentives to negotiate the structure of the lease as an operating lease even though other lessee incentives (such as a period of use equal to or nearly equal to the asset's useful life) may favor a capital lease. Debt covenants guarding against increased indebtedness are common. To the extent that they are common among current users of operating leases, leverage constraints are more likely to become binding on lessees is capitalization of operating leases is required. This has the potential to put some lessees in technical default on their outstanding debt.

Accounting rates of return (such as the return on invested assets) are frequently used either explicitly as a measure of managerial performance in compensation contracts or implicitly by compensation committees in setting overall compensation. To the extent that such arrangements are common among current users of operating leases, a requirement to capitalize those leases may alter incentives for managerial performance, or provide managers with incentives to alter their firms' financing policies.

El-Gazzar, et al., have provided empirical evidence that these two factors are related to leasing decisions. They found that in the pre-SFAS 13 period firms that had high debt-to-equity ratios and/or had incentive-based contracts based on income after interest expense were more likely to have leases classified as operating leases. However, it should be noted that these factors will affect leasing decisions only to the extent that existing debt covenants and managerial compensation contracts are not already designed to adjust for the effects of noncapitalized leases — such as debt covenants that specify a leverage measure based on liabilities inclusive of the present value of operating leases, or compensation contracts in which leased assets are factored into the return on assets measure.

This brief theoretical exposition suggests that a requirement that operating leases be capitalized could have adverse impacts on lessees due to (a) the costs of going into technical default on outstanding debt, (b) the costs of renegotiating debt contracts to avoid technical default, (c) the costs of restructuring leasing arrangements to avoid technical default or to avoid adverse impacts on managerial compensation, or the costs of other actions (e.g., debt reduction or asset sales) designed to offset the effects of lease capitalization.

Impacts Suggested by Informational Inefficiencies in the Market

In addition to the tangible financial incentives discussed above, the beliefs and perceptions of lessee company managers and outside analysts may play a key role in lessee managers' responses to a change in the lease accounting standard. Managers' beliefs about others' use of financial information as indicators of a company's performance are likely to influence managers' actions. Although many academic researchers, have concluded that capital markets as a whole are informationally efficient and cannot be fooled by cosmetic accounting changes, not all preparers or users of financial statements appear to share that belief.

If managers of lessee companies believe, for example, that users of financial statements evaluate their companies' performance according to reported accounting ratios (e.g., rates of return on assets, the reported ratio of debt to equity, and reported measures of liquidity) that are not adjusted to reflect operating leases, then such beliefs will likely affect managers' behavior. Managers may take actions to mitigate the perceived adverse effects of lease capitalization on those financial ratios. To the extent that users of financial statements behave as naïvely as some preparers of financial statements believe, such behavior on the part of users may be due to a lack of sophistication with regard to lease contracts, or mechanical application of reported financial ratios in the processing/screening of large volumes of data (as indicated in interviews with AIMR representatives).

Whichever incentives turn out to be the key drivers of managerial behavior in a specific instance, a lessee firm's response to the change in accounting standards is expected to depend on the relative costs of the available alternatives:

- renegotiating the parameters of contracts affected by lease capitalization,
- violating debt covenants and entering into technical default, or
- mitigating the financial statement impact of lease capitalization by undertaking offsetting capital structure changes (including potentially a host of changes representing substitution from capital leases and conventional debt into equity and other forms of off-balance-sheet financing — such as leases with initial noncancelable terms of less than one year, with contingent rent arrangements, or with other characteristics that would lead to operating lease treatment).

The specific response or combination of responses chosen by any given lessee firm will depend upon the relative costs and benefits of alternative responses. The magnitudes of a firm's responses will be determined by factors such as the magnitude of the new standard's impact on relevant accounting ratios and the amount of pre-adoption 'slack' relative to limits specified in affected contracts.

Changes in Lessee Behavior Suggested by Empirical Evidence

Some clues regarding likely lessee reactions to adoption of an asset/liability-based framework may be provided by empirical evidence on effects of the adoption of SFAS 13 — the last major change in lease accounting standards. Among other changes, SFAS 13 required that capital leases previously required only to be disclosed in footnotes would now have to be included at their present values in the lessee's reported assets and liabilities. While, to the best of our knowledge, no one has attempted to estimate the magnitude of the economic impacts of the adoption of SFAS 13, the reactions of lessees to the change have been carefully studied.

Imhoff and Thomas (1988) examined changes in the capital structure of lessees following the announcement of SFAS 13. They studied the three-year time period bracketing the adoption of the standard -- 1976 through 1978 -- and used 1980 as a "control period" for comparison purposes. They found that adoption of SFAS No. 13 was associated with significant changes in both capital structure and the structure of lease portfolios. Specifically, Imhoff and Thomas documented the following.

- There was a tendency for lessees to substitute from capital leases to operating leases.
- Firms employing relatively larger amounts of capital leases prior to adoption of the standard reported substantial declines in capital leases and corresponding increases in operating leases around the adoption of the standard.

- There was considerable substitution by lessees towards nonlease financing, as indicated by a decline in total leasing activity (operating and capital leases combined).

- Implementation of the standard was associated with leverage-reducing changes within nonlease sources of financing, as evidenced by increases in equity and decreases in conventional long-term debt. The magnitudes of these capital structure changes, which offset the expected financial statement impact of the standard, were related to firms' preadoption levels of footnoted capital leases.

Abdel-khalik (1981) was commissioned by FASB to study the economic effects on lessees of the adoption of SFAS 13. Using a combination of surveys and empirical studies, Abdel-khalik documented the following lessee responses to the requirement of lease capitalization.

- The majority of survey respondents indicated that the terms of new lease contracts were structured to avoid capitalization.

- 30 to 45 percent of respondents indicated an increase in buying or constructing assets instead of leasing them.

- About 45 percent of financial statement users and auditors and about 10 percent of chief financial officers indicated that existing lease contracts were renegotiated to avoid capitalization.

- In the three-year period following issuance of SFAS 13, many lessee companies changed their established patterns of financing in ways that mitigated the impacts of lease capitalization on accounting leverage measures. They were much more likely to engage in sales of common and preferred stock, retirements of long-term debt and conversions of bonds to stock in the years after issuance of the new standard than before.

- A survey of analysts and bank loan officers provided support for the belief that many users of financial statements give more favorable evaluations of companies that do not capitalize leases on their financial statements. A sample of U.S. bankers and analysts were asked to evaluate two companies that differed only in their method of accounting for leases. The respondents were provided with the condensed financial statements of the two companies and were told that the two companies were "almost identical (the difference lies in their method of accounting for leases)." Over 40 percent of the respondents considered the company that did not capitalize the 20-year noncancelable lease to be more profitable (8 percent considered the other company more profitable and 50 percent considered them equally profitable). More than 25 percent of respondents concluded that the company that kept its debt off the balance sheet had better debt-servicing ability. However, different results were found by Wilkins and Zimmer (1983) in a similar experiment with corporate loan officers from 35 international banks in Singapore. They concluded that lenders' credit evaluations were affected by the "real" levels of leverage of loan applicants, but not by their method of accounting for financial leases or by whether the loan applicants' debt financing was by term loan or financial lease. It cannot be ruled out that the differences in results of the two studies may be due to differences between the two samples of analysts in their level of sophistication and familiarity with lease contracts.

- Empirical evidence indicates that equity and bond market participants already take into account the risk of assets financed by noncapitalized leases. Abdel-khalik found no significant association between market-based risk measures (whether generated from stock or bond prices of lessee companies) and the events leading up to the implementation of SFAS 13. In other words, the accounting event appears not to have had an impact on investors' or analysts' evaluations of lessees' risk. Consistent with Abdel-khalik's evidence, a later study by Ely (1995) found a significant relation between equity risk and an estimated balance sheet adjustment factor for operating leases, as well as a significant relation between equity risk and an estimated adjustment to the return on assets to account for operating leases. Both Abdel-khalik's and Ely's evidence suggest that investors already evaluate operating leases as though they were capitalized on the lessee companies' balance sheets. If this is the case, then the change in accounting framework by itself may have no adverse impact on the shareholders or bondholders unless (a) there is currently a systematic bias toward underestimating the amount of lessee leverage implied by their operating leases, or (b) the change leads to changes in lessee behavior that are value-reducing (such as adopting economically less efficient lease structures that keep operating leases off the balance sheet).

Adoption of an asset/liability framework, as advocated by McGregor and others, would represent a much greater accounting change than the adoption of SFAS 13, though the key element of both changes is to disallow off-balance-sheet treatment for certain leases. Therefore, adoption of an asset/liability framework can be expected to result in changes in lessee behavior that are similar in nature to, but larger in magnitude than the changes cited in empirical research. The exception is that the McGregor approach would leave much less scope for the restructuring of what are currently long-term leases to maintain off-balance-sheet treatment. The costs of the required restructuring — including greater risk borne by lessors — would likely be too great in most cases to make such transactions worthwhile, though this proposition requires further empirical study. This comparison implies that changes in nonlease financing could be even greater in order to offset the impacts of capitalization on financial statements.

Potential Impacts Arising from Changes in Lessee Behavior

Having discussed the motivations that may lead to changes in lessee behavior, the remaining question is what economic impacts on the lease market may result from such behavioral changes. One key to answering this question is the answer to another question: What are the primary motives that drive a company to lease an asset rather than buy it? The answer to this question will vary from case to case, but will include tax motivations, the nontax factors discussed above, and accounting motivations.

Negative Impact on the Demand for Leases: For some companies, it may be the case that the favorable accounting treatment afforded to operating leases under the current standard is the overriding motivation for choosing to lease an asset rather than to purchase it. We have no data to indicate what fraction of operating lease transactions fall into this category. If lease capitalization were required, such companies may choose not to lease at all or to lease less frequently. This would result in a general and permanent reduction in the demand for leasing products, and would negatively impact lessor companies and intermediaries that participate in the financing of such transactions. Such a permanent reduction in the demand for lease products would result in a real loss in wealth to affected lessors — and possibly job losses among their employees — because lessor companies have invested a great deal of real and human capital over many years in developing the capability to structure operating lease transactions. Over the long-run, such dislocations would not necessarily represent large losses to the U.S. economy as a whole: those companies who would have financed assets with an operating lease would likely borrow funds to purchase them instead, and the capital that would otherwise have been invested in the leasing industry would be redirected to other uses. Nevertheless, the short-run dislocations would represent real economic costs to the affected lessors.

From the potential lessee's point of view, the loss of whatever economic benefit may be gained from off-balance-sheet financing would represent a cost. To our knowledge, the nature and magnitude of such actual or perceived benefits have never been systematically studied. Nevertheless, based on revealed lessee behavior, it is clear that lessees believe that such benefits exist. However, some (such as FASB Board members) have argued forcefully that the benefits to lessees of obtaining off-balance-sheet financing come at the expense of a greater cost to the economy as a whole — namely, economic inefficiencies that arise due to a lack of relevant financial information when important transactions are kept off the balance sheet. This is a claim that, while intuitively appealing, has yet to be supported by empirical evidence (to the best of our knowledge). It is a subject that merits further detailed study; and the FASB representatives interviewed for this study have expressed an interest in learning about the results of any such study.

Potential Shifts in the Structure of Leases Transactions: Switching to an asset/liability framework for lease accounting may give certain lessees an incentive to choose leases with shorter specified terms and more renewal options beyond the initial noncancelable period, as well as more contingency arrangements. In the case of McGregor's proposal, the resulting lease would have to feature an initial term of one year or less in order to avoid capitalization. Therefore, such incentives would be expected to apply only in such cases where a short-term lease can be made economical for both the lessee and lessor — such as where the lease would have otherwise been of relatively short duration (e.g., two to three years). A shift to shorter-term, more option-oriented leases would tend to shift the allocation of residual value risk (including obsolescence risk) more toward lessors. Lessors can be expected to charge a premium for assuming greater risk and offering greater flexibility; and some lessees may be willing to pay such a premium to maintain favorable accounting treatment. It is probable that the price charged by the lessor for bearing the additional risk will be higher than the price for which the lessee would have been willing to bear the same risk. This may be the case, for example, if a lessor is less familiar with the risks of the leased asset and the lessee's business than is lessee itself. Thus, a more restrictive standard operating lease accounting treatment may create incentives for less efficient risk sharing between lessees and lessors.

It should also be noted that the change in standards may lead to a lengthening of terms of some kinds of leases. In some cases where the decision to lease a long-lived asset is largely tax-driven, and where lease transactions are currently tailored to obtain operating lease accounting treatment, elimination of the possibility of operating lease accounting treatment may drive lessees to increase their lease terms in order to maximize the tax benefits of leasing. An empirical investigation of leasing arrangements would be required to determine whether and to what extent tax or other benefits are sacrificed in order to obtain off-balance-sheet treatment.

There may also be a real economic cost to the extent that existing leases are restructured to maintain operating lease treatment. Lessees and lessors may both experience otherwise unnecessary legal, accounting, and other transactions costs as they restructure their portfolios.

Distributional Impacts Among Lessees: There may be more pronounced effects on some types of lessees than on others -- for example, "small-ticket" lessees, such as lessees of office equipment (e.g., copiers, computer equipment, furniture). The internal capital budgeting processes of large corporations may provide incentives to lease such small-ticket assets rather than buy them. In general, lease payments may be considered as part of the operating budget of a company and require fewer approvals and less delay than outright capital purchase. So, district or regional managers of companies may choose to lease equipment rather than to purchase it with debt financing if it allows them to bypass the approval and scrutiny of headquarters — even though the cost of lease financing may be higher than debt financing. However, the same managers may balance the consideration of higher explicit financing costs against the benefit of greater flexibility and less delay in acquiring small-ticket equipment items. Being able to make and execute certain equipment-acquisition decisions without delay may have real economic value to some enterprises.

If leases with duration of more than a year must be capitalized, then the cost of such leasing activity would become apparent to corporate headquarters, which may prefer to centralize acquisition of small-ticket items and use debt financing alternatives that carry a lower explicit financing cost. This may have a negative impact on those lessors that specialize in small-ticket leases, but a positive impact on the economy as a whole if the benefits of reduced equipment financing costs outweigh the opportunity costs of reduced flexibility.

Other sorts of distributional impacts across industries are possible depending upon the relative levels of operating lease activity in different industries at the time that a new standard is adopted. For example, to the extent that operating leases of long-lived assets driven by nontax factors are relatively concentrated in certain industries, declines in the demand for leases in those industries due to the accounting change would be greater (in relative terms) than the decline for the lease market as a whole. This is because new acquisitions of long-lived assets under an asset/liability framework will be more likely to be financed by debt than under the current accounting standard if there are no significant tax or accounting incentives favoring a capital lease. An empirical investigation of the distribution of different kinds of leasing arrangements across industries would identify where the greatest impacts can be expected.

Potential Impacts on International Competition: As mentioned in the introduction to this report, international harmonization of accounting standards is one of the primary motivations that may lead to a reconsideration of lease accounting standards in the U.S. To the extent that U.S. accounting standards move to an asset/liability lease accounting standard before other developed markets, lessees in the U.S. may be put at a competitive disadvantage relative to competitors in other countries. For example, it may be the case that a lessee located in a country that has not adopted an asset/liability-based accounting standard will be able to raise capital at a lower cost because the relevant capital markets may not recognize the impact of operating leases on company financial statements. If this occurs, that foreign lessee will gain a comparative advantage over competitors operating in countries where capitalization is required.

Top (#top)

Equipment Leasing and Finance Association
1825 K Street NW, Suite 900
Washington, DC 20006
Phone: 202.238.3400 | Fax: 202.238.3401