The Value of Identifying Operating Leases

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In recent years, lease accounting has been the subject of much controversy. Both U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS) currently separate leases into operating leases or capital/finance leases. On their balance sheets, companies report assets and liabilities related to capital leases, but not operating leases. Critics claim that the off-balance-sheet treatment of operating leases not only fails to reflect economic reality, but also plays a major role in distorting companies’ financing decisions.1 Partly in response to such criticisms, both the Financial Accounting Standards Board (FASB), which governs US GAAP, and the International Accounting Standards Board (IASB), which governs IFRS, have proposed revised lease accounting standards that will require the capitalization of all long-term leases, and will distinguish leases only on the basis of whether or not they pertain to real estate. A recent study of ours suggests that investors gain valuable information from the identification of operating leases, which the proposed rules will eliminate.

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1 See, for example, “Hidden in plain sight” by Tim Reason, CFO Magazine (August 2005).

Investors benefit from knowing a company’s use of operating leases to the extent that the choice of an operating lease reveals something about the company. On the one hand, if operating leases merely serve to hide liabilities, as some critics assert, then leasing perhaps reveals something about the character of management. On the other hand, if business conditions drive the choice of operating leases, then observing a company’s operating leases can tell investors something about the company’s exposure to business conditions that lead to the choice of leases. We find no association between leases and incentives to hide liabilities; however, we do
find an association between leases and business conditions.

The business drivers of operating leases do not derive from their accounting classification, per se, but from the fact that the current accounting classification of leases exhibits a high degree of overlap with how the bankruptcy and tax codes classify leases. Business conditions drive companies to seek “true lease” classification under the bankruptcy and tax codes, which typically results in the lease receiving operating lease classification for accounting purposes. Operating leases provide investors with a gauge of a company’s use of true leases, which can be informative about the company’s business conditions.

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Why Do Companies Seek ‘True Lease’ Treatment? Academic studies have identified three prominent business incentives for companies to use true leases. First, financially risky companies have greater access to leased assets than to assets purchased with debt. In a bankruptcy, lessors face relatively few hurdles and delays to recover assets when a lessee fails to pay. Unlike secured financing arrangements, leases are typically not subject to automatic stay rules in bankruptcies, and debtors have a limited time from the petition date to decide whether to assume or reject the lease. By reducing financiers’ costs of repossession, leases make them more willing to finance the assets of risky companies. Second, companies with low effective tax rates, like loss-making companies, benefit from true leases that allow a taxable company to own the asset and fully utilize the tax deductions from depreciation. Third, leases facilitate capacity adjustments because they typically entail lower transaction costs, in terms of both time and money, than alternative sources of financing. This makes leasing particularly attractive to small companies with relatively few opportunities to redeploy assets within their companies, and to companies with volatile or uncertain capacity needs.

What Evidence Is There That Misreporting Plays a Minor Role in Lease Choices? In a recent study of the airline industry, we examine the relative importance of economic versus reporting incentives to use leases. The airline industry provides an excellent setting for analyzing lease decisions because airlines face relatively low transaction costs for leasing that might otherwise discourage managers from using leases to hide liabilities. Using a battery of tests, we find evidence consistent with business incentives driving lease usage, and no association between leases and incentives to hide liabilities.

We examine several incentives to hide liabilities. First, we compare publicly-traded to privately-held airlines. Market pressures on management and a greater separation of ownership and control provide managers of publicly-traded airlines a greater incentive to hide liabilities. Nevertheless, we find that public airlines use significantly less leases than private airlines, and that this difference is driven by different business incentives to lease. In particular, smaller airlines tend to have greater financial risk, lower tax rates, less of an ability to redeploy leased assets, and have more volatile capacity needs. These differences drive their lower lease usage.

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Companies have an incentive to hide liabilities prior to going public or undertaking a major borrowing. We find no evidence of increased leases around these events, which contradicts the notion that the desire to hide liabilities plays a major role in leasing choices. We also examine public airlines for which we have data on CEO compensation in order to test for an association between leasing decisions and compensation-based incentives to hide liabilities. We find no association between leases and compensation-based incentives to hide liabilities, but we continue to find an association between leases and both financial risk and airline size, which relates to the ability to redeploy assets.

In sum, we find evidence that business conditions, such as financial risk, play a role in leasing decisions, but no evidence that misreporting plays a major role in the use of leases.

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2 See, for example, Table 1 in “Leasing, ability to repossess, and debt capacity” by Andrea Eisfeldt and Adriano Rampini, Review of Financial Studies (April 2009).

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4 This is also why sometimes firms that declare bankruptcy request that their lease agreements be treated like secured financing agreements. For example, subsequent to its bankruptcy filing in 2002, United Airlines took the position that some of its financing agreements should not be considered as lease for the purposes of bankruptcy code (United Airlines Inc. v. HSBC Bank USA N.A. 2005).


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Why Do Investors Benefit From the Identification of Operating Leases? To the extent that business concerns motivate lease usage, the ability to observe a company’s use of leases can help investors understand a company’s business environment and how the company adapts to it. For example, the heavy use of leases may indicate that the company faces financial risks that lead to high costs of and limited access to traditional debt.

We find that the use of leases adds incremental predictive power to other commonly used financial statement measures of risk.

Lease usage can indicate how managers deal with uncertainty about their overall capacity needs. The identification of true leases can help investors understand managers’ ability to adjust capacity in the face of uncertain demand, or learn the extent of demand uncertainty by observing the extent to which managers rely on leases. Such information helps investors understand companies’ environments and how they operate.

Investors can benefit from the separate identification of operating leases because they proxy for the use of true leases. This does not imply that the proposed capitalization of leases will reduce information but it does imply that the proposed lease categories will reduce information. The FASB and IASB could easily remedy this problem by requiring disclosures of the use of true leases, similar to what the current lease standards make available by identifying operating leases.