**ECONOMIC IMPACTS OF CAPITALIZING LEASES: THE ELF STUDY**

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The Equipment Leasing & Financing (ELF) Foundation issued a study on leases in December. We assume these elves were hoping Santa would present them a gift of no amendments to lessee accounting. After all, why report economic reality if you don’t have to?

Specifically, ELF issued “[Economic Impacts of the Proposed Changes to Lease Accounting Standard](http://www.leasefoundation.org/IndRsrcs/MO/LseAcctg/EcoImpactFINAL.pdf)” in an attempt to display the dysfunctional consequences of the [FASB’s exposure draft](http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175823559205&blobheader=application%2Fpdf) on the topic. The foundation empirically studied the impact of this proposal on more than 1,800 publicly traded companies. The results show deteriorations in corporate balance sheets and income statements, so ELF concluded the new lease accounting will be disastrous for the U.S. economy.

Before we lob grenades at the FASB for its lack of support for capitalism, let’s take a closer look at the study and its conclusions. When we do, we find biases and myths that render the report’s conclusions worthless.

Let’s begin with the comment letters. The FASB received about [800 letters](http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=1850-100) on this leasing project; upon reading them, one finds a number of concerns from the letter writers, including ambiguities in the exposure draft, the need for more explanation, the magnitude of implementation costs, and the problem of debt covenants. We dismiss these concerns and the letters in general because corporate managers acting in their self-interest have long orchestrated major campaigns to smear the FASB whenever it attempted to improve financial reporting. The number of letters doesn’t mean a thing; the source says it all.

While there are indeed some items that need conceptual editing, and perhaps even some parts that could use more explanations, these features too often are a smokescreen to force the FASB to compromise its principles to better align with managerial objectives. As to implementation costs, we think the argument silly for the necessary data should already be collected if these firms have good internal control systems, particularly in light of developing fair value disclosure requirements. Any firm that does not currently assimilate these data is admitting poor stewardship.

With respect to debt covenants, we thought that corporate managers and general counsel would have figured out that one should always include in these contracts a provision to hold accounting methods constant. And surely, these highly compensated legal minds are familiar with waivers and modifications of debt covenants, aren’t they? Any firm foolish enough not to immunize itself contractually from accounting changes deserves whatever consequences it faces.

With respect to the empirical analysis by ELF, for the most part, it is well done and corresponds closely with academic research over the last 30 years. In particular, ELF estimates the direct and indirect impacts from the capitalization of leases. As other studies have found, this research reports large increases to reported debt and some decreases to net income because of the front-loading effect in capitalized leases. Analysts (and our accounting students) have known this for decades…there is no news here.

The report also points out that these effects vary by industry and by firm. For example, the impacts are greatest for firms such as CVS and Walgreen and for industries such as banking and airline. The impact is smallest, of course, for those who do not employ leases.

For the U.S. economy, the study estimates the addition of $2 trillion of reported debt, an 11 percent increase, and a decrease in pre-tax income of 2.4 percent. ELF concludes that these effects will have deleterious effects on the economy and thus recommends opposing the FASB’s exposure draft. At this point, however, it confuses reported items on the financial statements with real and fictional constructs. The question the authors should be asking is whether the stuff currently omitted from financial reports is real.

In particular, is the lease obligation that arises in capital leases real? Of course. Does the non-capitalization of leases change this? Of course not! Because the lessee has signed a contract with a lessor that requires it to make certain future payments, the liability is real whether or not the firm records it. That’s why sophisticated financial analysts have been estimating lease obligations for at least two decades. That’s why rating agencies have been estimating lease obligations for several years. If you want to know the truth and the corporation does not disclose the truth, sophisticated investors and their analysts will make their own assessments and include them in their analyses.

Because of these changes in the reported numbers, the ELF study group posits “induced impacts” and claims a variety of dysfunctional consequences such as job losses and increased interest rates. Unfortunately, because the researchers ignored the fact that many financial analysts and investors already estimate the effects of leases and recast the financial statements accordingly, these induced impacts are exaggerated and thus misleading. Stock and debt markets already incorporate such information into their models; therefore, the aggregate effects of capitalizing leases are likely nil.

The authors mention the fact that capitalization will make cash flow from operating activities higher, but they do not emphasize it. We wonder whether this de-emphasis is because they don’t want to report any positive effects from adopting this accounting proposal. Further, if they continue to believe that markets are naïve in their assimilation of financial information, they would have to conclude that higher free cash flows imply higher stock prices.

We appreciate ELF’s empirical analysis of the effects on financial statements from capitalizing leases; that is well done and correct. But confusing fiction with reality leads the group into fundamental errors when it purportedly measures the induced impacts. Unfortunately, these erroneous effects lead it to will-o’-the-wisps for conclusions.

The FASB should move forward and require all leases to be capitalized. It desperately needs to “close the door” once and for all on this “off balance sheet” financing scheme. More importantly, such a standard would allow a reliable mapping of reality to financial statements. Then the financial reports would supply more meaningful information to investors and creditors.

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*