**THE ECONOMIC IMPACT OF CAPITALIZING LEASES:**

**THE CHAMBER OF COMMERCE STUDY**

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On February 16, 2012, the U.S. Chamber of Commerce (COC) issued a report that purportedly examined the economic impact of capitalizing leases as outlined in a recent FASB exposure draft. The actual research was conducted and published by Chang & Adams Consulting, but presumably was funded by the COC and various affiliates. The study claims dire consequences for the U.S. if the FASB continues on its course, including the loss of millions of jobs and the destruction of between $27.5 and $478.6 billion in U.S. Gross Domestic Product (GDP). If this were true, the Congress and the White House should declare the FASB a national villain, strip it of its funding, dissolve its charter, and tar-and-feather the board members and their advisers. Shame on the FASB!

These doomsday predictions border not only on the ridiculous, but also the whimsical. The study is flawed and would be easily rejected by all mainstream accounting and finance journals. Research rigor is absent. The real shame rests with the economists who carried out this awful “research.”

As an aside, we recently reviewed a similar study conducted by the Equipment Leasing & Financing (ELF) Foundation (“[Economic Impacts of Capitalizing Leases: The ELF Study](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/491)”). This research about the impact of lease capitalization on financial statements seemed reasonably good and consistent, as it replicated the results of similar academic studies carried out over the past 30 years. But, when ELF attempted to measure the induced economic impacts, the research became flawed. What we find amazing is the timing and the similarity of these studies. Did ELF coordinate its tactics with the COC? Are these independent studies?

Be that as it may, let us focus on the recent COC study, “[The Economic Impact of the Current IASB and FASB Exposure Draft on Leases](http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2012-02-08-IASB-FASB-CA-Report-FINAL-v-3-_2_.pdf).” This report:

“… specifically looks at how the proposed standard would negatively impact job creation, the health of the U.S. real estate sector, and liabilities of U.S. publicly traded companies. The report analyzes the current proposal and under a best case scenario estimated its economic impacts as:

* Increasing liabilities for U.S. public companies by $1.5 trillion;
* Increasing costs to U.S. public companies by $10.2 billion annually;
* Potentially reducing jobs by over 190,000;
* Decreasing U.S. household earnings by $7.8 billion annually; and
* Lowering U.S. GDP by $27.5 billion annually.

To generate such conclusions, the researchers estimated three factors:

* The reduced spending by firms due to the negative impact on several financial ratios.
* The increased interest on borrowing due to the recognition of increased risk because of the higher liabilities and decreased earnings.
* The reduced commercial real estate values as lease terms are expected to decrease.

Our first problem with the study is that the authors totally ignored accounting research. Their bibliography is merely a compilation of op-ed polemics, various “file references,” and a few economic studies. While we generally respect economic research, it should be noted that many economists are not familiar with accounting concepts, structures, and institutions. This study’s authors clearly have not read accounting research, else they would not have made the fatal mistakes found in this research. At the end of this essay, we offer a small selection of papers in accounting and finance journals that address lease capitalization issues more thoroughly. Not considering all of the relevant research is a sophomoric error.

Next, Chang & Adams confuse reported numbers with real numbers. When a lessee signs a contract to make periodic payments in exchange for property rights to some resource, the lessee becomes encumbered with a lease obligation. It does not matter whether the balance sheet reports the debt or whether it keeps it off-balance sheet—the obligation remains very real. Just let the lessee skip a payment or two and see what happens. The lessor (and the courts!) won’t care a tidily-wink whether or not the lessee’s balance sheet reports the liability.

Another fatal error is to assume that financial analysts and other market participants use reported numbers in some mechanical fashion. The wealth of the efficient markets literature suggests that generally this is not the case. In particular, ever since SFAS No. 13 was published, sophisticated readers of financial statements have used its required disclosures to capitalize leases and create their own pro forma financial statements. They then make their investment and credit decisions based on these improved and more economically realistic financial statements.

Credit rating agencies also incorporate lease disclosure information into the rating evaluation process. Pepa Kraft has examined this phenomenon in “[Rating Agency Adjustments to GAAP Financial Statements and Their Effect on Ratings and Bond Yields](http://raw.rutgers.edu/docs/seminars/Fall11/Kraft_CRAadjustments_12-9-11%5B1%5D.pdf).” Professor Kraft finds that pro forma capitalization statements do indeed affect both ratings and yields.

In other words, market participants already use capitalized lease numbers in their analysis. This finding implies that if the exposure draft turns into an accounting standard, there may be little movement in credit and equity markets even though the reported numbers likely will differ. The information is already impounded in stock prices and interest rates.

A better question is why should the FASB issue the standard given that the market already creates its own capitalized lease pro formas. We suggest two possible answers. First, all such capitalizations today involve estimates and will contain errors. If business enterprises have to measure and report lease assets and lease obligations, the user community will incur fewer estimation errors. Also, if there is a change, it will occur for unsophisticated users who are fixated on reported numbers, and this includes government workers and politicians. The reporting of more economically accurate numbers should improve the regulation process. At least, such information supplies these government employees with the tools for which they could make better policy decisions. Whether they use it is anybody’s guess!

At the end of the day we see this report for what it really is— a fear mongering attempt to prevent the FASB from doing what it should have done at least 30 years ago. Lease obligations are real debts of corporate America…they are liabilities...they belong on the balance sheet.

The U.S. Chamber of Commerce might be in favor of accounting distortions, but we are not. Let’s present in our financial reports improved information which reflects economic reality. Shame on the Chamber of Commerce for publishing this worthless research just to achieve its political goals!

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