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Judson Caskey finds most companies use asset leasing for business reasons, not accounting window dressing

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In February 2016, the Financial Accounting Standards Board (FASB) announced a major overhaul to the accounting rules for leases. The new rules require that all long-term leases be counted on corporate balance sheets as liabilities beginning in 2019. Current rules distinguish between debt-like "capital leases," which appear as liabilities, and "operating leases," which are treated as straight rentals and do not appear as liabilities. By recording liabilities for operating leases, the new rules will add more than \$1 trillion in liabilities to estimated total U.S. corporate liabilities of \$26 trillion, according to the FASB.

Historically, operating leases have been "off-balance-sheet" items, usually cited in footnotes of financial statements. Critics say that invites "window dressing," or using leases to understate company liabilities and, therefore, financial risk. But the rule change governing companies' reporting of operating leases — essentially, rentals of big-ticket assets like real estate and machinery — may be targeting an accounting abuse that is more imagined than real, new research suggests.

An [extensive study](https://www.anderson.ucla.edu/faculty-and-research/anderson-review/leasing/Documents/sites/faculty/review/publications/Caskey_Ozel_TAR-2016-0176R1.pdf)
([Documents/sites/faculty/review](https://www.anderson.ucla.edu/faculty-and-research/anderson-review/leasing/Documents/sites/faculty/review/publications/Caskey_Ozel_TAR-2016-0176R1.pdf)
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by UCLA Anderson's Judson Caskey and N. Bugra Ozel of the University of Texas finds companies' decisions to use operating leases, rather than debt or capital leases, are primarily driven by business strategy. More important, operating leases receive not only different accounting treatment, but also different legal treatment.

For example, the bankruptcy code treats capital leases as "secured financing arrangements" subject to similar rules as debt, whereas it treats operating leases as rentals. In the event of a bankruptcy, an operating lease needn't get tied up in court proceedings, whereas financiers of debt and capital leases must rely on the bankruptcy settlement.

Because operating leases afford more protection to financiers than capital leases, they help companies gain access to additional financing. They can also allow a company to get equipment without committing to owning it, a help in uncertain times. There are also favorable tax treatments that support leasing.

If decisions to use operating leases were largely motivated by a desire to disguise a company's finances, the study says, you'd expect to see heavy lease activity in situations "where managers

have strong incentives to window-dress their financial statements." The authors identify such situations, including periods before private companies take themselves public (and want to look as financially fit as possible), and periods before companies borrow heavily (and likewise want to appear healthy to get the best loan terms).

The working paper looked at leasing data from 1990 to 2012 from two separate groups of companies: 142 private and public airlines, because the airline industry has a long history of leasing jets; and the broad universe of 7,712 public U.S. companies. Overall, the authors found "no evidence that [accounting strategy] plays a major role in leasing decisions."

In the case of airlines, Caskey and Ozel found that privately held carriers — which don't have to worry about reporting quarterly financial data to Wall Street — actually rely on operating leases more than publicly-owned airlines. And in the broad sample of companies, the authors likewise found "no evidence" to associate leasing with efforts to alter reported financial data.

In an interview, Caskey said he was "somewhat neutral" on the value of the new rule. "On the one hand, it provides a bit of new information, beyond what companies currently report in footnote disclosures about leases," he said. "On the other, that information can be costly for companies to provide, especially smaller companies with limited accounting staff — and probably lots of leases."

Caskey, J., & Ozel, N.B. (2017). *Reporting and non-reporting incentives in leasing* ([Documents/sites/faculty/review/publications/Caskey Ozel TAR-2016-0176R1.pdf](#)).



Judson Caskey

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Judson Caskey focuses on both empirical and modeling research in financial accounting, specifically on the role of accounting disclosures within the context of informed decision making. His empirical research examines the information conveyed by financial reports and how investors use it. His current projects range from showing the correlation between

meeting earnings targets and a company's potential to compromise on employee safety to how individual firms' accounting policies should not affect their cost of capital.

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